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Gower Report on Investor

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The Stock Exchange

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# **Published Papers**

The following published paper(s) enclosed on this file have been removed and destroyed. Copies may be found elsewhere in The National Archives.

- House of Commons Hansard, 16 July 1984, columns 49-116 "Investor Protection (Gower Report)"
- 2. Cmnd. 9432: Financial Services in the UK: a new framework for investor protection HMSO, January 1985
- 3. House of Commons Hansard, 29 January 1985, columns 157-165 "Financial Services"

Signed (Mayland Date 21 January 2014

**PREM Records Team** 

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18 September 1985

## THE BIG BANG

The City is bracing itself for the big bang. The Government has issued its first set of earmuffs in its White Paper, "Financial Services in the United Kingdom: a New Framework for Investor Protection". Broking firms are poised to exploit the changing shape of the market, or are busily selling out part of their equity to other financial institutions. Banks and licensed dealers are thinking about becoming market-makers themselves. The City is expectantly awaiting the day when there is no longer a rigid distinction between the stockbroker, who acts as an agent for his client, and the stockjobber, who deals in the market on behalf of the broker.

The big bang began as a result of the Government's decision in 1983 to withdraw the OFT inquiry into the alleged restrictive practices of the Stock Exchange. People expected limited change. Instead, a revolution in the way in which City businesses carry out share transactions for their clients was sparked off. Nicholas Terry spelt out the arguments about the changes in dealing systems in the LBR in April last year.

But the big bang itself is but a small part of a much broader battlefront. The noise and the reverberations spread far. If a business no longer has to be a member of the Stock Exchange in order to make a market in shares, many different businesses and people can get involved in market—making. If I can act both as a broker and as a jobber acting as an agent for my client, and as a principal making my own book in shares, new conflicts of interest and new opportunities leap forward. But the decision to abandon single-capacity and go for dual-capacity on the Stock Exchange is taking place at the same time that many other

powerful forces are at work refashioning the financial industry.

## Convergence

The strongest pressure of all is what we could call "convergence". In the relatively secure world of the 1960s and 1970s, specialism was the order of the day and most financial businesses were small in scale and in their capital backing. Stockbrokers rarely went beyond their basic function of acting as agents on behalf of those wishing to buy and sell shares. Stockjobbers had a guaranteed monopoly over making markets in all the quoted equities and gilts in the United Kingdom; and only through them could an individual hope, via a stockbroker, to buy and sell. They were both regulated under the self-policing mechanisms of the Stock Exchange Rule Book. Buyers and sellers, it is argued, knew where they stood because every man's word was his bond; and the Stock Exchange disciplinary system was designed to weed out any corrupt players.

Building societies grew up as the main intermediaries between savers and borrowers wishing to buy houses. The mortgage market grew rapidly in the 1960s and 1970s, but there was little overlap with the banks until the end of the 1970s, when the deposit taking powers of the building societies became considerable and when the range of accounts they offered became more flexible. The banks, through their monopoly over cheque clearing, and through their strong physical presence in the high street, were the primary deposit takers and current account holders carrying out the myriads of transactions that make up a nation's economy. Until recently they did not get involved in the mortgage market and did not compete head-on with the building societies. The building societies were controlled and regulated under the 1962 Building Society Legislation, and

the banks under the Banking Act of 1979 which set up the licensed deposit taker system.

Insurance brokers largely confined their activities to placing risks on behalf of individuals and companies, with the large composite insurance companies, or into the Lloyds market. They had a rôle in the savings market, routing life insurance monies through to the life and composite companies for investment by those companies in Stock Exchange securities. Governed by the Insurance Brokers' Regulations Act of 1977, they served the insurance companies governed by the most recent Insurance Company Act of 1982. The Department of Trade and Industry keeps a watchful eye on the solvency and probity of insurance companies.

Retail activities in the high street were confined to the branches of the leading clearing banks and of the building societies. Shops kept out of financial services, and insurance brokers offered only a limited number of savings-linked insurance contracts. Estate agency was a separate activity growing out of the chartered surveyors profession, which had some links with the building society movement but was never integrated with the wider financial and investment scene.

The Unit Trust movement, which grew rapidly in the 1960s and 1970s, was largely undertaken by mail order, through newspaper advertisements, or through stockbrokers as intermediaries. It had links with the insurance industry through the development of unit-linked life policies, and these were marketed via direct sales forces and the insurance brokers.

As this survey reveals, although throughout the 1960s and 1970s most people thought they knew where they stood, and the activities of each individual type of business was fairly clearly delineated in people's minds, the barriers

between them were beginning to break down. In the 1980s, the demolition job has become rapid and dramatic.

The underlying conflict between banks and building societies became more obvious as the building societies grew and represented more formidable competition for the limited pool of public deposits available. Their high interest accounts, their flexibility on their share account over withdrawals and payments, coupled with their freedom from the overheads on the clearing system, made them formidable competitors of the banks for the extra pound of retail deposits. So the banks counter-attacked by offering a mortgage system, and they turned out to be good at arranging larger and more flexible mortgage packages for many borrowers - already, of course, having access to the retail market through their strong branch network.

It was Lloyds Bank who saw the opportunity for entering estate agency in order to produce a fuller package of services to the home buyer and seller. The Black Horse agencies rapidly became the largest chain of other estate agencies in the country, and may well have led the way to further integration and wider geographical coverage of other estate agency chains. In the house market there is a natural tendency for people to want to offer a complete service comprising estate agency to buy and sell the house; lending powers to offer mortgages; insurance activities to both insure the property itself and to offer savings-linked insurance contracts for endowment mortgages.

In the insurance business, the clear divisions between investment, the buying and selling of securities, and insurance itself, was being eroded throughout the previous two decades. The advent of unit-linked assurance showed how far this process could go. Contracts were devised where the insurance part was a very small part of the total, in order to take advantage of the favourable tax treatment of

insurance contracts as a savings mechanism. The abolition of premium income relief in the 1984 Budget has done much less damage to this business development than many at the time expected, for insurance funds still offer a substantial tax shelter to the higher taxpayer, and still represent a common route of regular savings for the standard rate taxpayer.

It will be a natural development for those involved in the marketing of unit-linked insurance policies to consider expansion into the retail end of the business, to attract the savings in the first place; and to consider developing their own capacity for buying and selling the underlying investments in which the premiums are placed. The development of strong businesses like Hambro Life and Abbey Life showed just how powerful a mechanism for accumulating savings unit-linked assurance can be.

In the Stock Exchange itself, the large institutional investors were in the position of having all the clients' money at their disposal, but no direct powers to buy and sell shares themselves. Conversely, the broking and jobbing firms had relatively little capital resources, even after the process of amalgamation of jobbing businesses throughout the 1960s and 1970s had reduced the numbers and increased the size considerably.

Some halting attempts were made to break the Stock Exchange monopoly by the establishment of the Ariel dealing system. This succeeded in its first aim of reducing commission rates for larger deals undertaken by the institutions through the regulat stock market, but never succeeded in its wider aim of providing a high volume, cheap competitor successfully trading large blocks of shares on a regular basis. Institutional dealers never really trusted each other through the Ariel system, and it was unable to demonstrate the attractions and flexibility of the regular stock market.

However, in recent years there has been some development of an informal block trading market between institutions, cutting out the intermediaries of broker and jobber; and more recently, Robert Fleming has decided to make its own noise ahead of the big bang by setting up a trading desk in electrical shares in the UK market.

Meanwhile, the large investment institutions and banks had developed skills in markets parallel to the UK Stock Exchange. The Eurobond market, which grew explosively over the last ten years - primarily as a mechanism for routing the large oil surplus monies after the Middle East explosions - taught the banks and institutions a great deal about primary market-making. Specialist houses similarly learnt about market-making through the informal over-thecounter market in smaller companies; whilst a larger number joined in the formation of LIFFE, the London International Financial Futures Exchange. This market has a different and more modern and raucous flavour to it than the old Stock Exchange. On the Futures Exchange, the open shout principle of the commodities markets was adopted; market-making was opened up to banks and brokers as well as to the jobbers from the equity exchange; and a wider range of institutional professionals was brought in to make and service the market.

At the retail end, modest changes are also beginning. When Quilters paired up with Debenhams, at the time of British Telecom's flotation, to offer British Telecom shares through Debenhams stores, a novel departure was under way in British investment and financial business. The subsequent announcement that Quilters were going to establish, on a regular basis, share shops in some Debenhams stores, is confirmation that the stock market is now turning its mind to retail service. Many of the larger stockbrokers are contemplating how best to service this growing retail market, and see that the trend towards more private client business is likely to grow as a result of rising affluence

and the clear thrust of Government policy towards wider wealth-ownership.

The banks and the buildings societies have a lead in the development of retail business. But the Post Office, too, has the largest UK counter network used to handling clerical and financial transactions, and could become involved; whilst the larger retail chain stores, who are turning to the idea of sub-letting space, could also develop quickly into financial retailers by sub-letting space to professionals.

## The Government White Paper

The background to the Government's White Paper was the imminence of the big bang changes in the Stock Exchange, and a growing realisation that more was afoot than simple changes in the way of executing Stock Exchange bargains. The history of British regulation to date has been one of separate legislation and Orders in Council, regulating different types of institution but keeping them isolated one from another. This was feasible in a world where insurance companies largely did insurance, where Stock Exchange businesses largely transacted Stock Exchange transactions, and where there was a clear distinction between all of them, a building society and a bank.

But in a world of convergence - facilitated by new technologies which enable instantaneous computation and transmission of data - something more comprehensive is required. To do this, the Government wisely went back to first principles. The Government needed a new definition of investment to include the wide range of new instruments. Financial and commodity futures, options contracts, life assurance and Stock Exchange securities all had to come under the remit of the new regulators.

Those carrying out investment businesses - which could include the provision of advice and/or the management of investments themselves - under the White Paper proposals are to be regulated under an authorisation procedure.

Any business wishing to undertake the wide range of activities included under the definition of investments - which includes the publication of tip sheets (but not publication of a regular newspaper with financial comment) - will have to satisfy the regulators that it is fit and proper. "Fit and proper" covers probity, competence, and adequacy of financial resources. Probity and competence will be assessed by looking at the range of the Directors and their support staff, and their qualifications and experience. The adequacy of financial resources is likely to be related to the type of business being conducted. You obviously need far more capital to run a gilt trading book than you do to publish a tip sheet from a back room in Croydon.

These powers, which lie with the Secretary of State to authorise businesses, will be delegated to the two new bodies being set up, under the legislation, to carry out the regulation and supervision. The Securities and Investment Board, and the Marketing of Investments Board, will overlook the whole panoply of different types of business; and it is quite possible that the two will in due course merge into one as the distinctions between those involved in marketing investment plans, and those executing transactions, is already very blurred. They have a common secretariat to facilitate any such move.

The rules for the conduct of business are also set out in the White Paper. There is to be a principle of fair dealing, a duty of skill care and diligence, and a duty of disclosure. These are widely drawn requirements, but their thrust is that an individual should know what he's talking about; he should reveal his own interests; he should endeavour to ensure that his client is treated fairly; and that the marketplace is tested to get the client a good deal. When acting as an agent, there is a specific "best execution" principle and a "subordination of interest" principle, which means that he is charged with getting the best price he can, given the market circumstances; and ensuring that his client's interest is looked after before his own. The investment business has to protect its client's assets (ie safe keeping of monies and documents of title) and there has to be compensation for investors who lose out through fraud, negligence or a failure to look after their physical assets properly.

Investment and dealing recommendations have to be "adequate and reasonable", given the nature of the investment and the circumstances of the client. The terms of business have to be disclosed, proper records have to be kept, and the business has to be conducted in an orderly manner.

Whilst the activities and regulations of the two Boards will be specifically exempted from the competition and fair trading legislation, the Secretary of State will retain powers to order the Board to change its rules if, in his view, it is detrimental to the workings of the competitive market.

In the Unit Trust sector, the Government proposes authorised Unit Trusts which can be promoted to the public generally, and restricted Unit Trusts for professionals only. The insurance industry, under the Marketing of Investments Board, will be under a duty to disclose its commission structure to its clients, whilst it will retain the rule that it is a criminal offence to make misleading, false or reckless statements or forecasts about investments when advertising or promoting them. Insider dealing will continue to be a criminal offence.

The wide-ranging scope of the Government's White Paper shows just how complicated the problems are, and underlines the rapidity of change. The decision to keep the rules and discussion at a fairly high level of generality is a wise precaution, in view of the rapid changes of activity and style of contract in the wide-ranging financial markets. The strength or weakness of the system will lie in the practitioners on the Regulatory Boards. Can they produce regulations which have teeth, but which only bite when investment businesses or marketing businesses go beyond the line of reasonable commercial practice? Will they succeed in preventing fraudsters and consters marketing and dealing in shares for the public, whilst not preventing any new business starting up that is bona fide but may not have much resource to begin with?

There are three forces that underline the White Paper that are timeless, benign and powerful. These are caveat emptor; the power of competition; and the importance of disclosure.

#### Caveat Emptor

Anyone looking at the complexity of financial products must recognise that, in the end, the person who has most interest in checking out the investment, and ensuring that he has not been twisted, is the ultimate customer himself. Whilst the financial world can be intimidating and worrying to many, people are, on the whole, pretty canny about their own money. As the White Paper remarks, the best way to foil cold calling for bogus investment products is for the person being cold called to hang up the telephone, or to politely refuse. The most likely way in which the pedlars of risky investents will be thwarted, is by the basic common sense of the British public, who will continue to hold their life assurance contract and their British Telecom shares, and will not be tempted into Get-Rich-Quick Limited.

But the caveat emptor principle alone is not sufficient, as in this complex world, crooks and consters could still flourish. This is where disclosure and competition are important.

## Competition

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The best check on whether one business is being run reputably, and offering a fair deal or not, is the ability for the person to go down the road to another business offering the same competing service. When the fixed commission structure was abolished in the United States, commissions for larger bargains fell dramatically. It demonstrated that the market under a fixed commission system had been overcharging for all but the smallest bargains. When the informal commission agreement amongst estate agents broke down in the United Kingdom, the average percentage fee came down quite quickly from something like 2.5% to 1.25% in London.

If there becomes a general fear of a number of flimsy investment businesses being set up, where the intentions of their proprietors are less than honourable, it will become a strong marketing card in the hands of the reputable businesses that they are well-established, reliable and trustworthy. The presence of a competitor always tightens up the quality of service and keeps prices under careful scrutiny. As soon as profits become too large, with the pickings too easy, new providers will enter the market and bid them down again.

#### Disclosure

Disclosure is every bit as important as the caveat emptor rule and the competitive pressures. Without full disclosure - as with the case of commissions on some unit-linked policies - it is difficult to guarantee that competitive

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forces would be benign from the customer's point of view. With disclosure, competitive forces can be entirely benign.

More disclosure is needed in many areas of investment business. In the case of insurance brokers placing insurance business, life business, and unit-linked contracts, the level of commission or the nature of the commission agreement will have to be revealed.

In the Stock Exchange itself, even more rigorous disclosure is required so that the client can satisfy himself, in the complex world after the big bang, that his broker, agent, principal or whatever, carrying out the transaction for him, has done him the best deal possible.

The disclosure has to take several forms. Firstly, the client needs to be satisfied that he is not the tail end Charlie of a whole string of transactions largely designed for the profit of the investment business itself. It would be one of the easiest tricks in the book, once an investment business can act as a principal in the Stock Exchange marketplace, for a corrupt business to buy some shares for its own account, and then to drive the price higher in the marketplace by buying large numbers of the same share for its own clients, only then to sell out to make a good trading profit within the account.

To combat this possible conflict, the client needs to be informed of the market position in those shares of the investment business itself. This is common practice in the United States where, for example, brokers sending out recommendation circulars have to put on the circular how many shares they hold, and whether they are active in that share or not.

The client next needs to know that the deal was transacted at a fair price in relation to the range of other

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transactions going on in the market. At the moment, it is difficult for a client to be sure how well or badly his broker has dealt. He receives a contract, which states the date of the deal and the price. His only usual point of reference is to compare it with the stated closing price in one of the leading national newspapers. He will often be dismayed to find that he has succeeded in buying a share well above the closing price, or in selling it well below. If he is of a sceptical turn of mind, this will worry him; but his worries may be entirely unfounded. He may have sold at a lower price merely because the closing price in the newspaper is a middle market price, and he of course would receive the bid price. The shares may have fallen during the day, only to rise again near the close, and his broker carried out the transaction in the middle of the day when the shares were lower.

To deal with this problem, the contract note sent to the client needs to contain not only the date of the transaction, but also the exact time at which the transaction was undertaken. For ease of comparison, the electronic running tape of the new marketplaces should contain an average or guide price, or a most recent deal price, which could be put on the contract as well; and this could include, if the investment business chose, the spread between bid and offer price, as well as the simple middle market price.

The client also needs to be sure that the commission, or other remuneration charged by the investment house for the transaction, is reasonable. At the moment, the client either receives a contract specifying the standard broker's commission, which is fixed by the market; or he receives a net price contract rendered by a principal. In this case, he will not be aware how much the investment business is making out of the contract notes they have delivered. Under the régime outlined in the White Paper, it will be incumbent

upon the investment business to deal in such a way that the client is no worse off, having dealt with the investment business acting as a principal, than he would have been had he dealt through some other dealer in the market.

This seems a generally acceptable rule, and it is fair both ways. The client can then be sure that the commission charged on him is not out of all proportion, because he knows that he could not have dealt better elsewhere; whilst the investment business also benefits because, if it does have a relative advantage in dealing in one share or another for a perfectly good business reason, then it can make money out of so doing.

## Regulation

P. Parkey

The enthusiasm for regulation and the need for it are obvious to all politicians and many practitioners looking at the problem. But we should be careful lest we lay too great a stress on the powers of regulation. For in the end, the only people who know whether a business is being well run or badly run, whether it is corrupt or fair, whether it is exploiting or performing a good service, are the people running the business itself. It is difficult for regulators to ask enough questions to satisfy themselves they have enough information and to be sure that it is accurate, so that they can guarantee that all those businesses practising in the financial markets are indeed fit and proper, and conducting their business in an orderly fashion.

The Bank of England would be the first to admit that the task of regulation is a difficult one. They have a strong system of regular returns from banks, and a highly qualified staff who do nothing but examine the banking returns and try and foresee difficulties in the rather limited sector of the financial market covered by authorised banks. Yet the tragedy of JMB still occurred, and it was discovered that

one of the banks under their supervision had the most extraordinary portfolio of bad loans, with a high concentration of lending to one or two borrowers. The results have been only too clear. Imagine then the complexity and difficulty of the task for the two fledgling Regulatory Boards to be sure that all the businesses under their ambit are indeed performing a sensible function in a workmanlike way, and to be sure that there is no crookedness going on.

This is why the regulators will need the support and the assistance of the ordinary criminal law. It will still be illegal to insider trade, to make fraudulent statements, to run off with other people's money, or to use their assets for purposes other than those that have been authorised in your original contract of appointment. And these legal powers will have to be used to the full to remind the Directors of businesses that they are not merely meddling with the regulations of some intermediary body, but that if they go too far they are undertaking criminal practices for which the sanction may not be reprimand or a fine, but may be internment.

## Likely Regulatory Problems

S. Berry

The regulators themselves will face many conflicts, just as the new enlarged financial conglomerates face conflicts of interest between their different activities.

The first problem is to strike some balance between the desirable aim of making the markets as competitive as possible, and the regulators' duty to deny businesses unsuited to be practitioners access to the markets. If the regulators become too cautious, they will ban those very new businesses which could provide new life and innovation in the marketplace because they lack experience or cash. Yet it may be the single-man business, or the small group of individuals who wish to break away from an existing larger

business, who are most likely to have drive and imagination.

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There will also be a conflict between the wish to trade with less capital, to cut prices to offer a better service, to be aggressive in seeking market share on the one hand; and on the other the understandable prudence of regulators wanting businesses to have reasonable profit levels, high asset backing, good solvency, and not to be too aggressive in going out after new business for fear of transgressing rules on fraud and the representation of their products.

The conflict is enshrined in the Secretary of State's suggested powers. Whilst taking the Boards out of the normal framework of competition law - recognising that their very rules themselves would tend towards the cartelisation of the activity - he retains the right to order them to cease certain kinds of regulatory practice because it has become anti-competitive.

Fears about cartelisation will obviously be magnified because the bulk of the regulators themselves will have to be practitioners. It is difficult for an outside group of people to understand all of the activities and to be able to ask all the right questions. But if there were no outsiders the public might be forgiven for thinking that a new cosy club has sprung up. It is a short step from regulation to the endorsement of a cartel; and once there is a cartel, it is natural for the customer to have to pay more in order to pay for the cartel and its superstructure. The regulators will have to be on their guard lest they become the new carteliers of the financial world.

The second conflict is one all regulators face. Do they have a duty to keep a business going because it is providing a service for its clients, and if it were to cease trading many of those clients would be let down; or do they have a

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duty to stop the business trading because its capital is no longer adequate for its purposes?

It is the same conflict that the Civil Aviation Authority faces every day when it looks at the balance sheets and financial statements of the air travel industry. Should Laker have been bankrupted earlier by the CAA removing its permits, on the grounds that it was likely to become insolvent? Was the CAA too slow in pulling the plug on Courtline, when it was apparent to many financial analysts for months beforehand that the airline was likely to go bust and leave its creditors with insufficient cover? Should the Bank of England close a bank like JMB much earlier, to prevent the losses building up, knowing that if it does so it ruins that bank for a long time, as the removal of Bank of England support will remove all confidence from the institution?

The new City regulators will face a challenge every bit as tough as that faced by the CAA and the Bank. Should they let it be known in the marketplace that they are investigating more precisely the solvency of a given gilt trading business? If they do so, very few people will then want to trade with that business, and they may precipitate the very solvency crisis that they are worried about, even when their initial inclination to investigate it may have been ill-founded and the business may have been sound.

On the other hand, if they fail to investigate and the business does indeed go bust, won't its creditors feel aggrieved that the Board offered them no comfort? Is it possible to carry out these investigations without arousing City fears? The City is a small village; the news is likely to travel very quickly. Is it possible to devise a regular reporting system for all the businesses so that it is obvious from such a reporting system that a business is in trouble, without having to undertake any special

investigation? Is it realistic to suppose that the Board will feel confident enough, on the basis of what must be fairly sketchy regular reports from each business, that a given business is in trouble, without making a special investigation?

These are not easy questions to resolve, because they lie at the heart of the difficulties of regulation.

The third conflict the Board will face concerns the pace of change. It is a natural temptation for a regulator to be wary of change, because novelty may breed new problems. Yet if the Board becomes too conservative, it will either breed wholesale evasion of its regulatory practices within the UK market; or, worse still, will encourage a large amount of business to move offshore outside its clutches. The regulators will need skill in accepting that investment transactions and investment products will change rapidly.

Perhaps the worst problem of all facing the regulators is how they should brace themselves for scandal. In a fastmoving and wide-ranging set of marketplaces - like those growing up in London - there are bound to be scandals from time to time. No-one can guarantee that the combined forces of competition, disclosure, criminal law, and regulatory mechanisms will ensure that no crook ever flourishes, that no customer is ever conned. The purpose of the legal and regulatory framework must be to limit the scope and size of scandal, and to make the conditions as hostile as possible to criminal activity. The regulators will need considerable wisdom and skill in riding out the first scandal to break under their period of office; they have to avoid either clamping down too much, in the usual "bolting the stable door after the horse has gone" method of regulation; and avoid treating it so cavalierly that people do not believe they are serious about stamping out corruption in the marketplace.

## Will the Public be Better Served?

Some cynical observers looking at all the changes wonder whether any good will come of it. They suggest that transaction fees on Stock Exchange investments may go up for the small purchaser; that the larger financial institutions will simply grow bigger and will become large financial conglomerates; and that, at the same time as single-capacity is being broken down on the Stock Exchange, different changes are taking place in response to scandal at Lloyds to split up functions more clearly and to get away from the conflicts of interest that can lie in being both broker and underwriter.

But the trouble with the cynics is that they can offer no way of holding back the floodgates of change or of servicing all the different market requirements that are growing up. Financial services worldwide is an exploding, fast-growing industry. Those practitioners and marketplaces that have been most ready to adapt to change, and to be open to new ideas, have - as always in economic life - been the most successful at winning business and activity.

The United Kingdom economy is going through a revolution in the way it is financed and the way it is owned. The vast growth in home-ownership has itself fuelled the major expansion of the building societies and led to the inevitable conflict between building societies and banks. House finance cannot be split off from the rest of financial activity, especially now that a large amount of mortgage money is effectively withdrawn from the housing market and recycled into consumer spending or other types of investment activity.

You cannot stop the lenders of money to house-buyers getting involved in estate agency; nor can the tide be reversed where a new generation of people who inherit houses they do

not need for themselves will sell them and have investment funds available for stock market and other investments.

We live in a world where insurance companies have perceived the links between insurance contracts, savings and investment. And in a world where the combined forces of the movement for employee shareholdings, privatisation and the development of new small businesses points in the direction of more and more share-ownership and trading.

In one sense, the economy and the people are already better served by the changes so far. Starting from a position where Britain had one of the worst formation rates for new business in the Western world, we have already reached a record number of new companies, and have over a million incorporated businesses. We are developing, from a very poor start, a venture capital industry which can finance these small businesses and, in due course, bring them to market. Through launching the Unlisted Securities Market, we have provided a halfway house for the medium-sized company not ready for the costs and pressures of full quotation, but needing more outside shareholders and access to a market that can supply more equity capital.

Through the over-the-counter market and the Business Expansion Scheme, we have found mechanisms for channelling money and new shareholders into the smaller businesses which have outgrown the banks as a method of providing them with all their investment capital.

For the small shareholder, we should begin to offer a wider range of choice, a clearer statement of costs, benefits and transactions, and direct retail access. Too many of the British public have been put off owning and holding their own shares through the complexities of the transaction system, and the reputation of existing practitioners of the stock market as being unapproachable to all but the rich.

Our banks and buildings societies are beginning to see their rôle in wider financial planning for a typical family. A family doesn't just need a current account, a life insurance policy and a pension plan. A family may well need saving schemes tailored to mature at different points in its life cycle. The pressures of house buying in the early years, of school fees or other family outgoings in the middle years, of health plans, and then of retirement, all provide different periods of high saving and high cash consumption in a family's budget.

The credit revolution, which has opened up many new ways for individuals to borrow money through credit cards, mortgages, bank loans, overdrafts, loanbacks against pension insurance contracts, as well as the traditional hire purchase, is also part of this greater flexibility for the customer. It brings its own dangers of over-expansion of credit risk assessment problems.

We must always remember that the only reason for this whole complex financial superstructure is to see that individuals, families and businesses are well served. The mirror image of the needs of the individual and the family are the needs of business. The markets are there to channel the savings of the individuals into the new businesses, or to expand or renovate the older ones. We are at last in this country building more flexible and powerful methods of taking people's savings and investing them in risk capital activities.

It is important that this process continues, and that these new markets are seen to be fair, easily accessible, well policed, and continue the broad tradition of honourable dealing which characterised the old Stock Exchange. But it is also important that these markets are regulated and supervised by wise regulators who do not panic when

something goes wrong, but who do not appear to be an easy pushover in the hands of experienced wide boys.



## 10 DOWNING STREET

From the Private Secretary

26 June, 1985.

CGT EXEMPTION OF GILTS AND QUALIFYING CORPORATE BONDS

The Prime Minister and the Chancellor discussed his minute of 26 June this afternoon, and it was agreed that an amendment to the Finance Bill should be introduced along the lines proposed.

(Andrew Turnbull)

Mms. Rachel Lomax, HM Treasury.

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## Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

PRIME MINISTER

# CGT EXEMPTION OF GILTS AND QUALIFYING CORPORATE BONDS

You will remember that when we were considering last month the press notice about disclosure of tax decisions affecting gilts, I mentioned that we might want to amend the Finance Bill to deal with a difficulty with the indexation proposals for capital gains tax as they affect gilts. Peter Rees referred to this possibility during the Committee of the Whole House on the Finance Bill on 8 May. We subsequently included a specific reference to it, as a matter under consideration, in the press notice about disclosure of tax decisions affecting gilts.

- 2. The difficulty arises because of an asymmetry in the CGT treatment of gilts and corporate bonds that qualify for CGT exemption (qualifying bonds) if they are held for more than 12 months. Investors can choose, if they are showing a loss, to realise it to set against CGT on other gains by selling before the 12 month period is up: while, if they are showing a gain, they can avoid CGT by waiting a year before selling. So the system generates tax losses more often than taxable gains.
- 3. The extension of CGT indexation to short term losses and gains opens the possibility of much larger scale exploitation of this asymmetry than hitherto by financial institutions, with a corresponding loss of revenue, since it increases the scope for CGT losses. On the basis of information that has become available since the Budget, the Inland Revenue now believe that the full year revenue cost could be at least £60/70m, and maybe as much as £200m. (At the time of the Budget, their best estimate of the cost was only £10m)



## Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

PRIME MINISTER

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- 4. I have concluded that I must act to close off this loophole which has already attracted some press comment. The best, and simplest, solution is to remove gilts and qualifying corporate bonds from the ambit of CGT altogether. The Bank of England's advice is that this change will have an adverse effect on the gilts market and on market liquidity. (You will recall that they took a similar view before we announced the anti-bondwashing measures in February.) Nevertheless, I believe many will welcome the total abolition of CGT on gilts and qualifying bonds; and that in the longer run it might even improve the liquidity of the gilts market. The step should be seen as a welcome simplification for the taxpayer.
- 5. There is a legal complication that means that the change cannot be brought into operation until 12 months after the date of announcement. Counsel's opinion is that the specific statement that has always accompanied gilts prospectuses that CGT exemption only applies if the gilt is held for more than 12 months carries with it the implication that the gilt will not be exempt from CGT if sold within 12 months. I am advised that this could be regarded as an inducement to purchase stock, and that a change could expose the Government to a claim for loss in respect of all gilts sold on the basis of the existing statement. Because this can be regarded as a specific inducement made at the time of sale, it is not (and could not have been) covered by our press notice on disclosure.
- 6. We can, however, avoid any significant risks on this score by making the change operative 12 months after the date of announcement. Those who had bought before the announcement will still have their expected 12 months in which to realise losses to set against CGT gains. This should also help to reduce any adverse market reaction of the kind expected by the Bank.



- 7. I therefore propose to table a further amendment to the Finance Bill (which would otherwise have introduced CGT indexation for gilts and qualifying bonds on 28 February next year), so as to maintain the pre-Budget treatment of CGT on disposals until the 12 months period is up.
- 8. For market reasons, I want to announce these changes early next week, by means of a Written PQ and Answer on the lines of the attached draft. This would be made available to the market through a Revenue press release, which would also contain the draft Finance Bill Clause, to be introduced at Report.

N.L.

26 June 1985

# DRAFT PARLIAMENTARY QUESTION AND ANSWER

#### QUESTION

To ask the Chancellor of the Exchequer if he has yet decided whether it is necessary to deal with the problem of losses for capital gains tax purposes referred to by the Chief Secretary in the House on 8 May (Official Report, 8 May, Column 819).

## ANSWER

At present, gains on gilt edged securities and qualifying corporate bonds are exempt from capital gains tax if the securities are held for more than twelve months. Following a review of this treatment in the light of the introduction of the accrued income scheme, and as a further measure of simplification, it is now proposed to exempt these securities entirely from capital gains tax.

This exemption will apply to disposals of gilts and qualifying corporate bonds on or after [ June] 1986 and to avoid further complication, amendments to the Finance Bill indexation provisions will be proposed so that they have no application to these securities.

As a result, taxpayers will no longer need to keep records or include these securities on their tax returns for capital gains tax purposes. At the same time, it will remove the possibility that the CGT indexation provisions could be used to establish short term capital gains tax losses on these instruments, where counter-balancing gains would not normally arise because holders would delay realising gains until twelve months after purchase.

The Inland Revenue are today issuing a Press Release giving further information about these proposals and of the necessary legislative changes. The changes will be introduced at Report Stage of the Finance Bill.





## 10 DOWNING STREET

From the Private Secretary

24 May 1985

## DISCLOSURE AND GILTS

The Prime Minister has seen the Chancellor's minute of 22 May. She is content with the revised text and agrees that the Notice should be issued as soon as market circumstances permit.

I am copying this letter to John Bartlett (Office of the Governor of the Bank of England).

Andrew Turnbull

Mrs. Rachel Lomax, H.M. Treasury.

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(ii) it reeds time to make and arrowing decitions in a coherent way; that

(iii) we are doing no more than restore the Status que.

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# Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

PRIME MINISTER

## DISCLOSURE AND GILTS

- I attach a redraft of the Treasury Notice that takes account of the points raised at your discussion last week with the Governor and myself. The main changes from the previous draft are sidelined. They have been agreed with the Governor.
  - 2. If you are content with the revised text I think the Notice should be issued as soon as possible; the precise timing will of course need to take account of any new issue of stock we are making and be agreed with the Bank.
  - 3. I am copying this to the Governor.

N.L.

22 May 1985

## DRAFT TREASURY NOTICE

# Disclosure of Tax decisions affecting Government Securities

The Government is in a unique position in that it both has responsibility for the tax system and is a major issuer of securities. From time to time, tax changes are considered that could specifically affect the terms of issue (express or implied) of those securities.

It has been understood that, for the orderly conduct of fiscal policy, it may not always be possible to disclose decisions on such tax changes as soon as they have been taken, for example if the changes need to be announced together with other decisions in a Budget statement. However, in the course of preparation for this year's Budget, it emerged that there was an element of doubt as to the point at which a decision on the tax treatment of accrued interest on fixed interest securities should be disclosed. Accordingly, immediately after the Government had made its decision, the measure was announced by the Inland Revenue on 28 February, despite the close link between this measure and the proposals for reform of Capital Gains Tax announced later, in the Budget on 19 March.

Although the occasions when tax changes giving rise to such doubts are under consideration are likely to be infrequent, it is desirable to clarify the position for the future. The Government must be able to take its tax decisions in an orderly manner and announce them, with any related policy decisions, at an appropriate time. This means that on occasion some time may elapse between the point when a tax decision that may specifically affect the terms of issue of Government securities is taken and its eventual announcement.

For the avoidance of doubt, therefore, the Treasury wishes to make it clear that in the interest of the orderly conduct of fiscal policy, neither HM Government nor the Bank of England

#### CONFIDENTIAL.

or their respective servants or agents undertake to disclose tax changes decided on but not yet announced, even where they may specifically affect the terms on which, or the conditions under which, Government securities are issued or sold by or on behalf of the Government or the Bank. No responsibility can therefore be accepted for any omission to make such disclosure and such omission shall neither render any transaction liable to be set aside nor give rise to any claim for compensation.

A reference to this statement will henceforth be included in the documentation upon which Government securities are issued or sold by or on behalf of the Government or the Bank.

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#### CONFIDENTIAL



#### NOTES FOR EDITORS

Today's statement by the Treasury clarifies the position of the Government and the Bank of England in relation to Government securities issued or sold by them or on their behalf.

It makes clear that, as has always been understood, in the interests of the orderly conduct of fiscal policy some time may on occasion elapse between the point when a decision on tax that may specifically affect the terms of issue of Government securities is taken and its eventual announcement. As the statement explains, an element of doubt about the point at which the decision should be disclosed in the particular case of the recent measure to change the tax treatment of accrued interest on fixed interest securities led the Inland Revenue to bring forward the announcement of that measure, which would otherwise have formed part of the Chancellor's Budget statement.

The Treasury statement clarifies the position, and explains that a new paragraph will be included in future Government stock prospectuses and related documents.

The Chief Secretary to the Treasury told the House of Commons on 8 May that there had been suggestions that the CGT indexation provisions could be used by those seeking to establish a short term CGT loss on gilts and other debt instruments where counterbalancing gains did not normally arise. He said that if the Government were to conclude that any countervailing action were necessary it would be ready to introduce amendments to the Finance Bill at a later stage. Apart from this, the Government has at present no intention to introduce, nor has under consideration, any tax change affecting the terms of issue of any of its securities.

#### DRAFT PARAGRAPH FOR PROSPECTUS

#### Government Statement

"Attention is drawn to the statement issued by HMT on [date] which explained that in the interests of the orderly conduct of fiscal policy, neither HM Government nor the Bank of England or their respective servants or agents undertake to disclose tax changes decided on but not yet announced even where they may specifically affect the terms on which, or the conditions under which, this stock is issued or sold by or on behalf of the Government or the Bank; that no responsibility could therefore be accepted for any omission to make such disclosure; and that such omission would neither render any transaction liable to be set aside nor give rise to any claim for compensation."

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#### 10 DOWNING STREET

From the Private Secretary

16 May 1985

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#### DISCLOSURE AND GILTS

The Prime Minister discussed the Chancellor of the Exchequer's minute of 9 May at her meeting with the Chancellor and the Governor today. She considered that the advice which had been received by the Bank last February was extreme and unworkable. The Government was being put in the position where it could not consider proposals, take decisions on them and announce them in a coherent way. Adherence to this advice would make it impossible to construct a Budget. The Chancellor argued that the Government, as the tax authority, was in a different position from other operators in the market. This had been implicitly recognised for years and the aim of the proposed notice was to restore the position as it had previously been perceived. Both DTI and the Attorney General were content with the notice.

The Governor feared that issuing such a disclaimer could provoke an hostile reaction in the markets. Legislation was being introduced in the field of financial services which would require market operators to observe high standards of disclosure. The Government, as a major borrower, ought not to be seen to be putting itself above the law. He doubted whether changes in taxation which related specifically to the terms of gilt issues would occur sufficiently often for it to be worth incurring the risk of such criticism. The Governor conceded that the legal advice received last February was extreme, but he felt that it should be possible after further discussion to establish a middle way which would allow the Government to reach its decisions in an orderly fashion.

The Prime Minister said that, given this new advice, it would be difficult to achieve such a position. The Chancellor noted that the Bank were not prepared to sell gilts while tax changes were under consideration without an indemnity.

Summing up the discussion, the Prime Minister said the Government should not be prevented from carrying out its funding programme while it was considering tax changes. A notice should be issued but there were improvements which could be made to its wording which would reduce the public

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criticism. Greater emphasis should be put on the objective of returning the position to what people believed had been the status quo and to the fact that the Government was in a unique position as both a large borrower and the taxing authority. She invited the Chancellor and the Governor to consider with their respective legal advisers how the text of the notice and the accompanying notes to editors might be re-drafted to achieve a better presentation of the Government's case.

I am copying this letter to John Bartlett (Office of the Governor of the Bank of England).

You much

ANDREW TURNBULL

Mrs Rachel Lomax HM Treasury.

CONFIDENTIAL



## Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

13 May 1985

Andrew Turnbull Esq 10 Downing Street LONDON SWI

Dear Andrew,

#### DISCLOSURE AND GILTS

with the

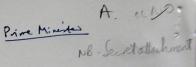
The Chancellor minuted the Prime Minister on 9 May attaching a draft Treasury notice and paragraph for the gilts prospectus. Further discussion with the lawyers has led to some minor changes to the notes for editors attached to the draft notice. I should therefore be grateful if you would substitute the attached redraft for the pages now in your possession.

The minute itself stands.

Jours even Raceal.

RACHEL LOMAX

Principal Private Secretary





#### Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

PRIME MINISTER

#### DISCLOSURE AND GILTS

We had a word about this on Tuesday evening. I thought it might be helpful if I set out the position as I see it.

- 2. You will recall that I was obliged to arrange for the decisions we took on bond-washing late on 27 February to be announced before the markets opened the following morning. This was on the basis of advice that sales of gilts by the Bank between the time of the decision and its announcement might be open to legal challenge on grounds of non-disclosure of a material fact. The need for a rapid announcement ahead of the Budget caused a great deal of inconvenience. You took the view that for the future we should seek to establish a position in which the Government was able to take tax decisions and announce them in a sensible manner. I wholeheartedly agree.
- My officials, and their legal advisers, have examined the options. There are three:-
  - (i) to amend future gilt-edged prospectuses and related market notices;
  - (ii) to legislate by amending the Finance Bill; or
  - (iii) to do nothing to change the legal position but to take such administrative steps as we can to minimise disruption in future.
- 4. Finance Bill legislation would be unnecessarily contentious and heavy-handed, while to do nothing to change the legal position would leave us open to a repetition of this year's events if we wished to avoid either a hiatus in the funding programme or possible legal action against us.



- 5. I therefore believe that the first option is the best. The Treasury would issue a press statement referring to the difficulty that arose on the bond-washing measures, and clarifying the position for the future. A reference to this statement would then be included in all future gilts prospectuses and to the Bank's press and market notices on gilts sales. This would explain that the Government did not undertake to disclose all tax changes decided on but not yet announced which might specifically affect the terms or conditions on which the stock was sold, and did not accept responsibility for any non-disclosure. I attach a copy of the press statement I have in mind and the related paragraph for the prospectus (though this is still subject to advice that is being sought from the Attorney General on the precise wording).
- 6. I am sure it is right to limit the statement to tax changes specifically affecting gilts. It is difficult to think of any non-tax changes specifically affecting gilts which a Conservative Government might wish to introduce. With no measurable benefit from widening the area where we seek protection, it seems best to minimise the risk of controversy by restricting the protection to tax measures.
- 7. As to timing, I should like the announcement to be made at the earliest opportunity. The Chief Secretary mentioned during the Committee of the Whole House on the Finance Bill yesterday the emergence of a possible difficulty with the indexation proposals for capital gains tax as they affect gilts, where we may wish to amend the Finance Bill. This strengthens the case for pressing ahead with the announcement I have in mind. If we were to approach a decision on the indexation proposals before a statement had been published on disclosure we would once again be faced with having to announce it as soon as it had been made, if not before.
- 8. The Governor is not convinced of the need for any change, however. He would prefer to retain the status quo, on the grounds that occasions of the kind that have caused difficulty are likely to be very few and far between. He is chiefly concerned that the change to the prospectus (and the associated Treasury statement) might be criticised as relieving the Government from responsibilities for investor protection which it is trying to reinforce in the Financial Services



Bill for other issuers of securities. But he is also concerned that a health warning of the kind envisaged might adversely affect sentiment in the gilt-edged market.

- 9. I think the Governor underplays the difficulties of retaining the status quo and the advantages of announcing all tax measures together in the Budget. I do take seriously the risk that the Government may be represented as seeking special privileges on disclosure; but the protection we are claiming is strictly confined to tax matters and is plainly in the interests of orderly Budget-making. My officials have consulted DTI, in view of their responsibility for the Financial Services Bill, who have confirmed they are content with the approach proposed. On the advice we have received from Treasury Solicitor and junior Treasury Counsel, subject to the Attorney General's conclusions, the risk of legal challenge seems minimal. I do not believe the market would be seriously upset by an announcement which reaffirms a position which everyone (including the Governor) had always believed to be the status quo.
- 10. The Governor has made it clear to me that he is prepared, reluctantly, to follow the course I recommend. But since he does feel strongly on the issue, I think it would be right if you and I were to discuss it with him early next week, before final decision is taken.

N.L.

9 May 1985

### SECRET

#### DRAFT TREASURY NOTICE

### Disclosure of Tax decisions affecting Government Securities

In the course of preparation for this year's Budget it became apparent that where certain proposals were being considered that could specifically affect the terms of issue (whether express or implied) of Government securities there was an element of doubt as to the point at which such proposals should be disclosed.

This question arose on the measure to be taken to change the tax treatment of accrued interest on fixed interest securities. The Government received advice that there was a strong case for announcing this change as soon as the decision had been taken. Accordingly, the measure was announced immediately by the Inland Revenue, on 28 February, despite its close link with the reform of Capital Gains Tax announced later, in the Budget.

Although the occasions when tax changes that could give rise to such doubts are under consideration are likely to be infrequent, it is desirable to clarify the position for the future. The Government must not be constrained from making decisions in an orderly manner, or where necessary from announcing related policy decisions at an appropriate time, for example in a Budget statement. This means that on occasion some time may elapse between the point when a decision that may specifically affect the terms of issue of Government securities is taken and its eventual announcement.

For the avoidance of doubt, therefore, the Treasury wishes to make it clear that in the interest of the orderly conduct of fiscal policy, neither HM Government nor the Bank of England or their respective servants or agents undertake to disclose tax changes decided on but not yet announced, even where they may specifically affect the terms on which, or the conditions under which, Government securities are issued or sold by or on behalf of the Government or the Bank. No responsibility can therefore be accepted for any omission to make such disclosure and such omission shall neither render any transaction liable to be set aside nor give rise to any claim for compensation.

#### SECRET

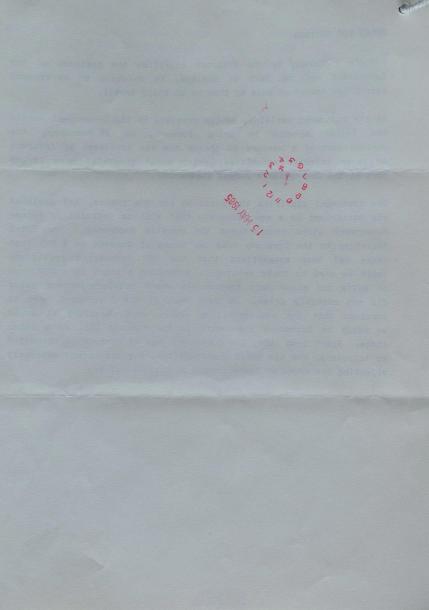
A reference to this statement will henceforth be included in the documentation upon which Government securities are issued or sold by or on behalf of the Government or the Bank.

#### NOTES FOR EDITORS

Today's statement by the Treasury clarifies the position of the Government and the Bank of England, in relation to Government securities issued or sold by them or on their behalf.

As the statement explains, advice received by the Government caused the Inland Revenue to bring forward, on 28 February, the announcement of a measure to change the tax treatment of interest on fixed interest securities, which would otherwise have formed part of the Chancellor's Budget statement.

The statement clarifies the position for the future, and explains the background to a new paragraph that will be included in future Government stock prospectuses and related documents. The Chief Secretary to the Treasury told the House of Commons on 8 May that there had been suggestions that the CGT indexation provisions could be used by those seeking to establish a short term CGT loss on gilts and other debt instruments where counterbalancing gains did not normally arise. He said that if the Government were to conclude that any countervailing action were necessary it would be ready to introduce amendments to the Finance Bill at a later stage. Apart from this, the Government has at present no intention to introduce, nor has under consideration, any tax change adversely affecting the terms of issue of any of its securities.



# DRAFT PARAGRAPH FOR PROSPECTUS

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To me

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# INSURANCE INSTITUTE OF LONDON PRESIDENT'S LECTURE

# The Regulation of Financial Services in the United Kingdom

Delivered by
Sir Nicholas Goodison
Chairman of The Stock Exchange

4th February 1985

### THE REGULATION OF FINANCIAL SERVICES IN THE UNITED KINGDOM

I was originally billed to talk to you about 'Current Developments at The Stock Exchange'. The title was as broad as it was vague. Rather than spread thin paint over a broad canvas I have chosen to concentrate on the subject of regulation. I do this for a number of reasons. First, it is a very important subject. Good regulation is the basis of confidence. Second, it is not only The Stock Exchange and its constituents who face changes in the regulatory framework under which they work: reform is going to affect everyone concerned with advising on or selling a wide variety of investments, including people in your own industry. Third, it is necessary to dispel some of the myths which are growing up around the subject. And fourth, it is topical. It is almost as if the organisers of this President's lecture, when they invited me to speak a year ago on this particular evening, had advance warning of the publication of the Government's White paper on investor protection a week ago. If this prescience was not a case of insider dealing, it surely reflects the collective foresight of your membership.

I shall examine this evening the way in which The Stock Exchange over the years has exercised its regulatory authority and the degree of success it has achieved in so doing. Then I shall discuss the main proposals which the White Paper puts forward for changing our system of financial regulation. Finally I shall attempt to emulate your prescience by trying to forecast the effect of these changes on the regulatory work of The Stock Exchange.

I shall attempt to avoid much of the jargon which increasingly surrounds this subject. Abstract nouns and phrases such as self-regulation, conflicts of interest, single or dual capacity and (most abstract of all) Chinese Walls, enable reformers and critics to sound very grand, very righteous and very learned. But they mean little outside the circle of practitioners who use them and they often obscure the real issues. Put at its simplest the purpose of regulation is to answer the questions which every investor is entitled to ask—

- will he receive detached advice?
- will he buy or sell at a fair price?
- how will he know that he has done so?
- will he be told what his agent, or the salesman from whom he is buying, is being paid?
- to whom can he complain and will he be treated fairly if he does?
- what are his legal rights?
- is he protected adequately against the default of his agent or of the salesman?

These are the questions that matter.

There are of course broader purposes which good regulation seeks to fulfil. First, our society has to be cohesive if we want to hold our place in the world and make some economic or social progress. We have to be confident that the laws, codes and conventions which govern any part of society, or any of our institutions, are fair. We want to know that ethical and moral standards are upheld, and that abuses, whether for political or commercial or personal reasons, are exposed and dealt with. If we do not do this, society will become generally immoral, political or financial greed will dictate the actions of the many rather than the very few, and our delicate system of political democracy will fall apart. Second, the link between trade and industry, on which we all depend for our standard of living, and the financial markets and institutions is very, very close. Britain's financial markets have, admittedly, succeeded through effort and skill and reputation in building on their domestic industrial foundation and become markets for the world. But they are nothing without domestic trade and industry. They exist primarily to serve trade and industry both in times of boom and in times of slump. Good regulation breeds confidence, attracts investors, and thus helps the liquidity of the markets for savings which industrial borrowers need. Bad regulation drives investors away and harms the interests of borrowers. Inefficient, bureaucratic, heavy-handed regulation obstructs efficiency and restricts the flow of savings into industry.

#### The Work of The Stock Exchange

The Stock Exchange Council occupies a central position in the regulation of financial markets. It lays down rules and codes of behaviour, organises the complex business of surveillance to check that people are conforming to the rules and codes, and forces them to do so through an array of disciplinary powers reaching right up (or is it down?) to depriving a wrong-doer of his right to carry on his trade. All this The Stock Exchange Council does with hardly any statutory powers.

How did The Stock Exchange come to be such an important regulatory body, and what in essence are

There is nothing unusual about the principle of non-statutory regulation. In every country, even in that most legalistic of societies the USA, the stock exchanges carry some of the load of regulating their own markets legalistic of societies the USA, the stock exchanges carry some by the Council of The Stock Exchange than and customers. Here, however, more of the load is borne by the Council of The Stock Exchange than and customers. Here, however, more of the load is borne by the Council of The Stock Exchange than and customers. Here, however, more of the load is borne by the Council of The Stock Exchange than one continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses are continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses are observed in the Rules and Regulations of 1812. Of the currency. Our present Rule Book is the direct descendant of the Rules and Regulations of 1812. Of the currency. Our present Rule Book is the direct descendant of the Rules and Regulations of 1812. Of the currency. Our present Rule Book is the direct descendant of the Rules and Regulations of 1812. Of the currency. Our present Rule Book is the direct descendant of the Rules and Regulations of 1812. Of the Rules and Regulations of 1812. On the Rules and Regulation

The Stock Exchange regulates the behaviour of its members, their standards of conduct, both in their relationships with their customers and with other practitioners in the market, and their financial standing, It also regulates the behaviour of the buyers and sellers of securities who are bound to abide by the "Rules, regulations and usages of The Stock Exchange" — a rule which has a very ancient lineage and which covers not only the rules which dictate market practice but also the complex rules which ensure the successful settlement of the 20,000 or so transactions which are carried out every day.

The rules which govern transactions in the market are the expression of the concern of The Stock Exchange to prevent improper dealings in securities. In addition to policing its market rules the Council monitors market activity, looking for unusual price movements and carrying out investigations whenever price movements or complaints justify doing so. The power to summon members of The Stock Exchange gives the Council the speedy access it needs to the necessary information. Again there is nothing new here. The investigation into the major gilt-edged fraud in 1814, which was based on the alleged defeat of Napoleon, was almost a model for one of our present day enquiries. The essential difference between now and 1814 is that in 1814 police action followed immediately. Within a couple of months of the then Stock Exchange's enquiry, the miscreants had attended the Old Bailey and received their just rewards. The speed of The Stock Exchange's action is the same today as it was in 1814, but any court action today, even assuming the Department of Trade and Industry feels confident enough to institute action, is a matter of years rather than weeks. I shall return later to the deficiencies of State regulation.

The Council's most formal role is the control over the securities which are traded in the market. The requirements are set out in our Yellow Book. This sets out in considerable detail the information which companies must disclose to their shareholders when they first come to the market, when they want to make acquisitions or sales which materially add to or reduce their current business, when they announce profits, or dividends, and so on. It also lays down minimum standards of behaviour for sensitive activities, such as dealings by directors and employees in the securities of their own company, and obliges companies to conform to external codes such as the Takeover Code.

Only recently, as many of your will be aware, we have been obliged to amend our Yellow Book to bring it into line with our national obligations, as the Government perceives them, under the newly implemented European Listing directives. In implementing these directives, the Government was sufficiently confident The Stock Exchange's experience and continuing ability to administer these regulations to designate on this legal responsibility. Our only concern is that the Government may have been too zealous in the way which has been so much a part of London's competitive advantage over other major financial centres, unhappy and growing trend these days.

In summary, The Stock Exchange's regulatory restrictions (a word I use deliberately) have over the years enabled us to secure high standards of conduct and integrity on the part of members, member firms, public confidence in the ethical and financial integrity of the stock protect investors and, above all, maintain in The Stock Exchange through a Stock Exchange member, or who ask a Stock Exchange member to be answered positively.

#### The Government's Proposals

That has not alas been true of the whole investment industry. The creaking framework of an inefficient law has increasingly opened investors outside The Stock Exchange to unacceptable risks, as the failure of certain firms of licensed dealers in securities and commodity fund managers has demonstrated, sadly to the cost of investors who probably thought that they were better protected than they were. These misfortunes were the direct consequences of the failure of successive governments to bring the law up to date or to do the job of regulation which under the present law they should have been doing.

The State has let investors down and, in the ironic way in which these things occur, has by its inaction caused a dent in the high reputation of the City of London.

We have argued for many years that the law governing the sale of securities needs re-writing and that other investments need to be brought into the net. The Government's White Paper tries to grapple with these needs. The failures of the past have been recognised and the Government will cease to have a day-to-day role in the regulation and surveillance of investment activities. All sorts of investments will be covered and not just securities. Both reforms are long overdue.

Let us look at the aims of the White Paper. The Government says that its aims are to enhance efficiency, competitiveness, confidence and flexibility (Chapter 3. 1). These aims are of course wholly laudable. It will not have escaped your attention that they are precisely the objectives that The Stock Exchange has pursued over the years and has largely achieved in its regulation of the central market in securities. The parallel with the way in which The Stock Exchange has regulated its affairs is even clearer when one studies the principles upon which the Government proposes to take action to achieve these objectives. I should like to read them out to you (Chapter 3.2):

- 1. Market forces provide the best means of ensuring that an industry meets the needs of its customers. If market forces are to operate properly it is essential that:
  - as much information as possible is disclosed about the investments and services on offer to the customer; and
  - the forces of *competition* are brought to bear on practitioners and their institutions.
- 2. The law should provide a clearly understood set of general principles and rules which facilitate:
- raising capital in the United Kingdom;
- investment and saving; and
- buying and selling of investments.
- Prevention is better than cure. The regulatory framework should make fraud less likely to occur in the first place.
- Vigorous enforcement of a simplified, clear investment law is necessary to deter fraud and malpractice.
- 5. Self-regulation has a continuing and crucial contribution to make. It means commitment by practitioners to the maintenance of high standards as a matter of integrity and principle, not because they are imposed from outside. Regulation should encourage the commitment of individuals in the financial services industry to high standards. It is in the interests of both the industry and its customers that the opportunity for theft, fraud and deception, the buying and selling of securities and investment services should be minimised.
- 6. If the law and the regulatory system are to be clear and fair there must be so far as this is possible equivalence of treatment between products and service competing in the same market. The law should not create artificial distinctions.

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How did The Stock Exchange come to be such an important regulatory body, and what in essence are its regulatory powers?

There is nothing unusual about the principle of non-statutory regulation. In every country, even in that most legalistic of societies the USA, the stock exchanges carry some of the load of regulating their own markets legalistic of societies the USA, the stock exchanges than and customers. Here, however, more of the load is borne by the Council of The Stock Exchange than and customers. Partly this is because we are older than most and have more experience. We have in most other countries. Partly this is because we are older than most and have more experience. We have in most other countries. Partly this is because we are older than most and have more experience. We have in most other continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses and collapses and collapses and collapses and collapses and collapses. The stock Exchanges are the stock exchanges are the collapses are collapses. In the collapses are continuous tradition, and collapses are collapses and collapses are collapses. The stock exchanges are collapses are collapses and collapses are collapses. The stock exchanges are collapses are collapses and collapses are collapses. The stock exchanges are collapses are collapses and collapses are countries. The collapses are collapses are c

The Stock Exchange regulates the behaviour of its members, their standards of conduct, both in their relationships with their customers and with other practitioners in the market, and their financial standing. It also regulates the behaviour of the buyers and sellers of securities who are bound to abide by the ''Rules, regulations and usages of The Stock Exchange''— a rule which has a very ancient lineage and which covers not only the rules which dictate market practice but also the complex rules which ensure the successful settlement of the 20,000 or so transactions which are carried out every day.

The rules which govern transactions in the market are the expression of the concern of The Stock Exchange to prevent improper dealings in securities. In addition to policing its market rules the Council monitors market activity, looking for unusual price movements and carrying out investigations whenever price movements or complaints justify doing so. The power to summon members of The Stock Exchange gives the Council the speedy access it needs to the necessary information. Again there is nothing new here. The investigation into the major gilt-edged fraud in 1814, which was based on the alleged defeat of Napoleon, was almost a model for one of our present day enquiries. The essential difference between now and 1814 is that in 1814 police action followed immediately. Within a couple of months of the then Stock Exchange's enquiry, the miscreants had attended the Old Bailey and received their just rewards. The speed of The Stock Exchange's action is the same today as it was in 1814, but any court action today, even assuming the Department of Trade and Industry feels confident enough to institute action, is a matter of years rather than weeks. I shall return later to the deficiencies of State regulation.

The Council's most formal role is the control over the securities which are traded in the market. The requirements are set out in our Yellow Book. This sets out in considerable detail the information which companies must disclose to their shareholders when they first come to the market, when they want to make acquisitions or sales which materially add to or reduce their current business, when they announce profits, or dividends, and so on. It also lays down minimum standards of behaviour for sensitive activities, companies to conform to external codes such as the Takeover Code.

Only recently, as many of your will be aware, we have been obliged to amend our Yellow Book to bring it into line with our national obligations, as the Government perceives them, under the newly implemented European Listing directives. In implementing these directives, the Government was sufficiently confident. The Stock Exchange's experience and continuing ability to administer these regulations to designate on this legal responsibility. Our only concern is that the Government may have been too zealous in the way which has been so much a part of London's competitive advantage over other major financial centres, may have been lost. The Government was influenced perhaps by some over-vigorous legal advice, an unhappy and growing trend these days.

In summary, The Stock Exchange's regulatory restrictions (a word I use deliberately) have over the years enabled us to secure high standards of conduct and integrity on the part of members, member firms, public confidence in the ethical and financial integrity of the stock protect investors and, above all, maintain in The Stock Exchange through a Stock Exchange member, or who ask a Stock Exchange member to be answered positively.

#### The Government's Proposals

That has not alas been true of the whole investment industry. The creaking framework of an inefficient law has increasingly opened investors outside The Stock Exchange to unacceptable risks, as the failure to creatin firms of licensed dealers in securities and commodity fund managers has demonstrated, sadly to the cost of investors who probably thought that they were better protected than they were. These misfortunes were the direct consequences of the failure of successive governments to bring the law up to date or to do the job of regulation which under the present law they should have been doing.

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second level of the hierarchy, namely the one or two supervisory bodies — the Securities and Investments Board for yours. These bodies will have the Board for our industry, and the Marketing of Investments Board for yours. These bodies will have the responsibility for authorising, and withdrawing authorisation from, investment businesses, a function at responsibility for authorising, and withdrawing authorisation from, investment businesses, a function at responsibility for authorising, and withdrawing authorisation from, investment businesses a function at responsibility for authorising withdrawing authorisation such as The Stock (and, presumably, withdraw recognition from) existing self regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self-regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self-regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self-regulatory organisations such as The Stock (and, presumably, withdraw recognition from) existing self-regulatory organisations.

There will be a Tribunal, to which those whose authorisation to conduct "investment business" is turned down or withdrawn by one of the Supervisory Boards will be able to appeal.

Let us not waste time discussing whether or not this is a scheme for self-regulation. It is not. The subsidiary bodies in the hierarchy will continue to regulate themselves, but so they would in a fully statutory system bodies in the hierarchy will continue to regulate themselves, but so they would in a fully statutory system bodies in the hierarchy will continue to regulate themselves, but so they would in a fully statutory system of regulation, reaching always for better standards than the law imposes in order to secure a competitive advantage. The new bodies are virtually statutory commissions with unprecedented delegated powers.

Will it work? Before trying to answer that question I would like to look at the relationships between the actors who will occupy the stage.

First, the relationship between the Secretary of State and his department on the one hand, and the Supervisory Bodies on the other. In present circumstances, the relationship between Government, the Bank and The Stock Exchange (who meet together regularly in The Stock Exchange Monitoring Group) is, in relation to the securities industry at least, very much a relationship of equals, with the Government perhaps filling the classic role of the Prime Minister in Cabinet of being primus inter pares. Under the White Paper proposals the Supervisory Boards would quite clearly be subservient to Government because:-

- their constitutions will be governed by the principles set out in the White Paper;
- the chairmen and boards will be appointed by the Secretary of State, in one case with the agreement
  of the Governor and in the other in consultation with "sectors of the financial services industry
  involved";
- the bodies will be required by statute to report annually to the Secretary of State who will lay their reports before Parliament;
- the bodies will be subject to the provisions of competition law;
- the decisions of the bodies will ultimately be referable to the independent Tribunal which will be appointed by the Secretary of State and financed by Government funds.

The fact that the bodies will be able to make rules having the force of law will virtually guarantee that Parliament will insist that the subservience of these Boards to the Secretary of State is beyond doubt.

Thus to all intents and purposes the Boards will be servants of the Government paid for by practitioners. This will have to be accepted.

Second, the relationship between the Supervisory Boards and the self-regulatory organisations such as The Stock Exchange. The Supervisory Boards will only grant "recognition" to an existing self-regulatory organisation if they are satisfied that it has and maintains "the ability to regulate the admission and conduct of its members and that its rules provide a standard at least equivalent to those of the Board's itself".

Clearly, large, sophisticated and well-regulated bodies such as The Stock Exchange will gain surveillance function to that of The Stock Exchange. And it is difficult to envisage the Supervisory Boards a parallel having once granted recognition, withdrawing it. In practice, a great deal of practical autonomy will be Board. To do otherwise would be inefficient and expensive.

Third, the relationship between the Supervisory Boards and the appeals Tribunal. This is in many ways the most sensitive and difficult relationship to predict. The Secretary of State alone will have the power of the Tribunal could undermine the authority of the Supervisory Boards. A great deal of thought needs to be given to this delicate relationship before the enactment of legislation.

Fourth, the relationship between the Securities Board and that other successful example of self-regulation, the Panel on Takeovers and Mergers. The Government's paper is silent on this. The position of the Panel, subsumed into a statutory framework.

And last, the relationship between the two proposed Boards themselves. There seems to me to be little point in having two Boards since the handling of different types of investment are tending to converge within firms both inside and outside The Stock Exchange and most businesses would have to register with both authorities. There may be a practical difficulty to begin with in agreeing the details of the regulation of life assurance and unit trusts, and this may need temporary arrangements before legislation is enacted. But I expect the two Boards to converge by then and see advantage in them doing so.

Each of these relationships poses problems which will have to be solved. But there is time to solve them, and I am assured that the provisions of the White Paper are not carved on tablets of stone.

Having said this, I cannot of course say with any certainty whether this structure will work, especially so far in advance of the legislation which will bring it into being.

Success will depend on at least five requirements. First, the new structure must maintain flexibility both in the application of rules and its procedures so that Britain can remain a competitive international capital market. Second, the detailed rules and procedures, which will presumably be devised before legislation obliges individual firms to apply for registration, must set a high standard and not compromise for the sake of either accommodating every practitioner or appeasing vested interests. Third, the members of the Boards and their staff must be of high calibre and drawn largely from practitioners who understand the task. Fourth, the method of financing the Boards must be fair and not tax again practitioners who are already well regulated or investors who are already well protected. Fifth, the directly registered practitioners, many of whom have no community of interest with each other, must be willing to conform to requirements promptly and without litigation.

If the structure does not work, there will be no alternative but to set up a statutory commission. Under this government the Department of Trade will have neither the political backing nor the resources to enable it to undertake the responsibility itself.

A statutory commission is likely anyway to be our ultimate destination, but to set one up in the immediate future would be a worse solution. It would introduce immediately into regulation a legalistic dimension which could do harm to Britain's competitiveness, and it would be unhappily devised without any of the evolutionary experience which the present proposals offer.

#### Effect of the Stock Exchange

I promised at the outset to attempt to emulate the prescience of your organisers by forecasting the effect all these changes will have upon the operations of The Stock Exchange. I hope that what I have said this evening will have enabled you to see through this disingenuous promise. It is not difficult to predict that in the new "practitioner-based" system of regulation that is being proposed by the Government, there will not only be a place for The Stock Exchange, but that its position will be in most respects identical to the position it occupies today.

I frequently see the comment that The Stock Exchange is being "'de-regulated". I also read that the new framework of regulation is needed particularly because of changes in The Stock Exchange. Both propositions are untrue. "'De-regulation" is another of those abstract buzz-words which obscure thought. The Stock Exchange will abolish two sets of rules — the rules obliging brokers to charge a minimum fixed commission and the rules obliging the separation for the most part of the activities of brokers and jobbers. In place of these two sets of rules The Stock Exchange will be writing a lot more, to ensure that standards continue at the highest level and that investors who invest their money through The Stock Exchange continue to enjoy the very high level of protection which they have enjoyed in the past.

Nor do the changes which we face within The Stock Exchange need a new Board to supervise them. We will ensure that new firms who come into our market conform to our rules and to our standards. In short The Stock Exchange, which will remain the largest most experienced regulatory body in the City, will continue to exercise the long and successful tradition of regulation, surveillance and enforcement for which it is well known. Why anyone should suppose otherwise, I do not know. It can only be due either to malice or to ignorance. Indeed, if anything, the changes will extend The Stock Exchange's work and thus solve part of the present problem, in that firms who have not in the past been directly regulated by it will be joining its ranks.

The gain to be made from the Government's proposals is not inside The Stock Exchange, but outside it. If the proposals are successfully implemented there is a hope that in two years' time there will be some improvement in the lot of investors who choose not to use a Stock Exchange firm. This is after all the chief aim of the proposals. The Government has set out to improve the regulation of dealers in securities outside. The Stock Exchange and to bring into the net investment products which are at present covered by no regulation.

I hope the aims will succeed.

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STATEMENT FOR THE SECRETARY OF STATE

With permission, Mr Speaker, I wish to make a statement about the Government's proposals to establish a new regulatory framework for the financial services industry. These proposals are published in a White Paper which I have today laid before the House and, subject to the Parliamentary timetable, I plan to introduce a Bill in the next Session for their implementation.

- 2 Modern technology and intense international competition are bringing about rapid changes in the financial services industry. The responsibility for responding effectively to these changes lies principally with the industry. The Government's task in this sector as in others is to create an environment in which it can do so. This is best done by allowing market forces to operate responsibly but without unnecessary constraints, in a way which promotes efficient and competitive business.
- 3 A prerequisite for an internationally competitive industry is a clear regulatory framework within which practitioners and customers can deal with confidence, and which safeguards the interests of investors. This regulatory framework must be capable of adjusting to changes in the shape of the markets, and of accommodating rather than stifling innovation.
- 4 This, the proposals set out in the White Paper are designed to achieve. They will assist enforcement, deter fraud and malpractice, improve disclosure and lay down the principles on which business should be conducted. The

proposals cover both a new regulatory framework and a new institutional structure through which it will work.

- First, the regulatory framework. This will be based on new and comprehensive definitions of investment and of investment business. It will be an offence to carry on an investment business in the United Kingdom without authorisation. To obtain such authorisation, an investment business will have to show it is fit and proper and will be required to observe detailed rules for the conduct of business based on principles to be set out in the legislation. Breach of these rules will be subject to sanctions up to and including the withdrawal of the authorisation to trade. There will be a number of important further changes. I intend to rationalise and update the legal provisions dealing with offer documents and the advertising of investments, first to make clear what must be disclosed and second to establish standard provisions on civil and criminal liability for omissions and mistakes. also propose to liberalise some restrictions on the unit trust industry and enable it, subject to appropriate safeguards, to offer a greater variety of schemes to the public. Commissions and other payments to intermediaries will be disclosed. As far as is possible, the marketing of life assurance contracts will be treated in a manner similar to the marketing of other investments.
- I now turn to the institutional structure designed to implement the new regulatory framework. It is based on my belief that the crucial tasks of authorising investment businesses and keeping high standards of business conduct amongst those so authorised can be discharged much more effectively by those closest to the market practitioners and their customers rather than by Government.

Malpractices can be identified and dealt with more quickly by these people than by Government regulators.

- I therefore intend to build upon what is best in self-regulation. I shall propose legislation to confer on the Secretary of State the necessary powers to grant authorisation to investment businesses; but also to enable him to delegate regulatory responsibility, including the power of authorisation, to one or more bodies composed both of those who provide and those who use financial services. Before doing so I shall be required to be satisfied on the composition, constitution and proposed rules of these bodies and I will have power to withdraw delegated powers in the event that such a body fails to continue to meet the criteria. Steps are already in train to set up the bodies. I hope that those concerned in the financial services industry will press ahead, so that the structure is in place by the time the legislation is on the statute book.
- The Government see great advantages in the system of self-regulation within a statutory framework. At the same time we recognise that self-regulation should receive statutory backing only if there is proper accountability. The White Paper sets out the detailed means by which accountability of these bodies to Government and Parliament will be achieved. I would highlight three particular statutory safeguards. First, there will be a right of appeal on authorisation and on penalties for breach of the rules to an independent tribunal to be appointed by the Secretary of State. Second, the Secretary of State will have the power. to be exercised on the advice of the Director General of Fair Trading, to revoke or amend rules which have anti-competitive effects. Third, the Secretary of State will have various powers of appointment. I believe our proposals combine the

advantages of self-regulation within a statutory framework and proper accountability to Parliament.

9 I have today set out the Government's aims; our proposals for a new regulatory framework; and our proposals for a new institutional structure. The White Paper contains many details which the House will no doubt wish to study and then debate. I look forward to the contribution to be made by those both within and without the House especially those with knowledge and experience in these matters. We have much benefitted already from the advice of Professor Gower, the Governor of the Bank of England, and of the groups chaired by Mr Jacomb and Mr Field.

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Secretary of State for Trade and Industry

#### DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET

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January 1985

C Marshall Esq Private Secretary to the Lord Privy Seal and Leader of the Commons Privy Council Office Whitehall London SW1

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FINANCIAL SERVICES WHITE PAPER A HAMMED

I wrote to you on 22 January to warn you of my Secretary of State's intention to make a statement introducing this White Paper today. I now attach a copy of the statement my Secretary of State shall make.

I am copying this to Tim Flesher (PS/No 10), Murdo Maclean (PS/Chief Whip), Chief Press Secretary (No 10) and Margaret O'Mara (Treasury).

Yours sincerely, Maureer Doesworth

MAUREEN DODSWORTH Private Secretary

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# Press Notice

# Department of Trade and Industry

1 Victoria Street, SW1H 0ET Press Office:01-215 5061 Out of hours: 01-215 7877

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29 January 1985

#### FINANCIAL SERVICES WHITE PAPER PUBLISHED

The Rt Hon Norman Tebbit MP, Secretary of State for Trade and Industry today announced the Government's proposals to establish a new regulatory framework for the financial services industry. These proposals are set out in a White paper "Financial Services in the United Kingdom: A New Framework for Investor Protection" (Cmnd 9432) published today.

The theme is self-regulation within a statutory framework. This will provide for investor protection while at the same time allowing the UK financial services industry to operate efficiently and competitively.

Legislation is planned for the 1985/6 Parliamentary session which will:

- make it a criminal offence for any firm to engage in investment business without being authorised as "fit and proper" to do so. Only those judged "fit and proper" will be authorised to carry on investment businesses.

- define investments and investment business

  comprehensively, to cover all types of security
  and to include for the first time financial and
  commodity futures and options.
- enable the Secretary of State to delegate the power of authorisation to one or more private sector bodies composed of practitioners and users of financial services. The Secretary of State intends to do this.

The White Paper envisages two bodies: a Securities and Investments Board, covering the regulation of securities and investments, and a Marketing of Investments Board, covering the regulation of marketing of pre-packaged investments such as life insurance and unit trusts. If the financial services industry and its customers subsequently prefer a single body, the Government would consider this.

These boards, and other self-regulatory bodies that they decide to recognise, will be responsible for formulating and enforcing rules of conduct for those they authorise to carry on investment business;

- the boards, which will be financed by the industry, are to be set up in the near future on a voluntary basis, so that the regulatory structure can be in place and operating by the time that the legislation providing the statutory framework is enacted;
- the boards will have the power necessary for them
  to be effective regulators. There will be safeguards
  designed to combine the benefits of an effective
  practitioner-based system with accountability to
  Government and Parliament including:
  - appointments to the Boards will be by or with the agreement of the Secretary of State;
  - ii) the Secretary of State will be empowered to get the bodies to change their rules if, on the advice of the Director General of Fair Trading, he believes that they are anti-competitive, or if they conflict with international obligations;
  - iii) a right of appeal by investment businesses to an independent tribunal appointed by the Secretary of State.

Speaking today in the House of Commons, Mr Tebbit said:

"With permission, Mr Speaker, I wish to make a statement about the Government's proposals to establish a new regulatory framework for the financial services industry. These proposals are published in a White Paper which I have today laid before the House and, subject to the Parliamentary timetable, I plan to introduce a Bill in the next Session for their implementation.

Modern technology and intense international competition are bringing about rapid changes in the financial services industry. The responsibility for responding effectively to these changes lies principally with the industry. The Government's task - in this sector as in others - is to create an environment in which it can do so. This is best done by allowing market forces to operate responsibly but without unnecessary constraints, in a way which promotes efficient and competitive business.

A prerequisite for an internationally competitive industry is a clear regulatory framework within which practitioners and customers can deal with confidence , and which safeguards the interests of investors. This regulatory framework must be capable of adjusting to changes in the shape of the markets, and of accommodating rather than stifling innovation.

This, the proposals set out in the White Paper are designed to achieve. They will assist enforcement, deter fraud and malpractice, improve disclosure and lay down the principles on which business should be conducted. The proposals cover both a new regulatory framework and a new institutional structure through which it will work.

First, the regulatory framework. This will be based on new and comprehensive definitions of investment and of investment business. It will be an offence to carry on an investment business in the United Kingdom without authorisation. To obtain such authorisation, an investment business will have to show it is fit and proper and will be required to observe detailed rules for the conduct of business based on principles to be set out in the legislation. Breach of these rules will be subject to sanctions up and including the withdrawal of the authorisation to trade. There will be a number of important further changes. I intend to rationalise and update the legal provisions dealing with offer documents and the advertising of investments, first to make clear what must be disclosed and second to establish standard provisions on civil and criminal liability for omissions and mistakes. also propose to liberalise some restrictions on the unit trust industry and enable it, subject to appropriate safeguards, to offer a greater variety of schemes to the public. Commissions and other payments to intermediaries

will be disclosed. As far as is possible, the marketing of life assurance contracts will be treated in a manner similar to the marketing of other investments.

I now turn to the institutional structure designed to implement the new regulatory framework. It is based on my belief that the crucial tasks of authorising investment businesses and keeping high standards of business conduct amongst those so authorised can be discharged much more effectively by those closest to the market - practitioners and their customers - rather than by Government.

Malpractices can be identified and dealt with more quickly by these people than by Government regulators.

I therefore intend to build upon what is best in selfregulation. I shall propose legislation to confer on the
Secretary of State the necessary powers to grant
authorisation to investment businesses; but also to enable
him to delegate regulatory responsibility, including the
power of authorisation, to one or more bodies composed both
of those who provide and those who use financial services.
Before doing so I shall be required to be satissfied on the
composition, constitution and proposed rules of these bodies
and I will have power to withdraw delegated powers in the
event that such a body fails to continue to met the
criteria. Steps are already in train to set up the bodies.
I hope that those concerned in the financial services

industry will press ahead, so that the structure is in place by the time the legislation is on the statute book.

The Government see great advantages in the system of selfregulation within a statutory framework. At the same time we recognise that self-regulation should receive statutory backing only if there is proper accountability. The White Paper sets out the detailed means by which accountability of these bodies to Government and Parliament will be achieved. I would highlight three particular statutory safeguards. First, there will be a right of appeal on authorisation and on penalties for breach of the rules to an independent tribunal to be appointed by the Secretary of State. Second, the Secretary of State will have the power, to be exercised on the advice of the Director General of Fair Trading, to revoke or amend rules which have anti-competitive effects. Third, the Secretary of State will have various powers of appointment. I believe our proposals combine the advantages of self-regulation within a statutory framework and proper accountability to Parliament.

I have today set out the Government's aims; our proposals for a new regulatory framework; and our proposals for a new institutional structure. The White Paper contains many details which the House will no doubt wish to study and then debate. I look forward to the contribution to be made by

those both within and without the House especially those with knowledge and experience in these matters. We have much benefitted already from the advice of Professor Gower, of the Governor of the Bank of England and of the groups chaired by Mr Jacomb and Mr Field.

The Government's proposals offer advantages to investors, to industry and commerce, and to the financial services industry itself. To the investor, our proposals offer more comprehensive protection against fraud or negligence, and be tter and fuller information on which to make investment decisions. To industry and commerce they offer the prospect of keener and more innovative financial services and therefore of finance at cheaper rates. To the financial services industry, they offer a system administered by those familiar with the markets and without unnecessary Government involvement. The high standards which we seek to promote will be in the interests of all."

### NOTES TO EDITORS

- "Financial Services in the United Kingdom. A New Framework for Investor Protection". Cmnd 9432. HMSO £4.65.
- The framework proposed for City Regulation was outlined by Mr Alex Fletcher, Minister for Corporate and Consumer Affairs in a statement on October 17 1984.
- 3. "Review of Investor Protection: A Report. Part 1." Professor LCB Gower. Cmnd 9125. HMSO £9.90. Was published in January 1984.

- 4. An interim document entitled 'Review of Investor Protection. A discussion document" by Professor Gower was published in January 1982. HMSO £6.60.
- 5. Professor Gower was commissioned by Mr John Biffen the then Secretary of State for Trade, in July 1981, to carry out an independent review of investor protection.

# WHITE PAPER ON FINANCIAL SERVICES IN THE UNITED KINGDOM

- A new Framework for Investor Protection

## SUMMARY OF THE MAIN PROPOSALS

Norman Tebbit, the Secretary of State for Trade and Industry, today publishes a White Paper setting out proposals for legislation to reform the regulation of investment business. The main elements of the proposals are as follows:

THE REGULATORY SYSTEM

The new regulatory system will have the following features:

a <u>definition of "investments"</u>, which will <u>include</u> in addition to securities covered by the Prevention of Fraud (Investments) Act 1958 (the "PF(I) Act"), the whole range of financial and commodity futures and options contracts, and certain other products. The definition of investments will <u>exclude</u> property which passes under the direct physical control of the investor if purchased (eg commemorative medals). The Department of Trade and Industry will continue to be responsible for the prudential supervision of insurance companies; the marketing of life assurance contracts will be treated as far as possible on the same footing as other similar investments;

a <u>definition of "investment business"</u> which will include, for example, any business which effects transactions in investments with or for others, manages investments (including unit trust schemes) or gives advice about them. There will be various exclusions including companies issuing their own shares, newspapers, and investment clubs. Individuals will not be included unless they propose to carry on investment business as sole traders:

provisions making it an offence to carry on investment business as defined without authorisation; and

provisions giving the Secretary of State authority - which he will be empowered to delegate to regulatory bodies which appear to him to satisfy criteria laid down by the legislation - to grant, vary, make subject to conditions, suspend or revoke such authorisation and to lay down requirements for the conduct of business by those authorised. These requirements will include the application of a "fit and proper" test to all investment businesses: sole traders, partnerships and corporate entities.

Rules for the conduct of business will be based on principles set out in the legislation. These new principles are based largely on existing good market practice in the UK and USA. They are as follows:

- i. safeguards against abuses arising from conflicts of interest. For all investment business, this will entail:
- a principle of fair dealing;
- a duty of skill, care and diligence; and
- a duty of disclosure.

For agency business, this will entail in addition:

- a 'best execution' principle; and
- a 'subordination of interest' principle.
- ii. protection of clients' assets, whether money or documents of title.
- iii. compensation for investors.
- iv. investment and dealing recommendations should be adequate and reasonable, having regard to the nature of the investment and the circumstances of the client.
- v. disclosure of the terms of business to customers.
- vi. the keeping of proper records.
- $\ensuremath{\text{vii}}$  . arrangements to ensure the orderly conduct of business.

CRITERIA FOR DELEGATION BY THE SECRETARY OF STATE

The main criteria for delegation will be that:

the body's proposed requirements are such as to ensure that those authorised by it are and remain "fit and proper" to carry on investment business;

its proposed conduct of business rules will afford adequate protection to investors and are consistent with basic principles set out in the legislation; and

### INSTITUTIONAL STRUCTURE

The Government favour practitioner-based regulation within a statutory framework. The arrangements recommended by the Governor of the Bank of England after consultation with leaders of City institutions, and by representatives of the life assurance and unit trust industries, envisaged two

practitioner-based regulatory bodies, a "securities and investments board", and a "marketing of investments board" covering in particular life assurance and unit trusts. However, the legislation will in no way prevent delegation to a <a href="mailto:single-practitioner-based">single-practitioner-based</a> regulatory body.

There will be provision for the Boards to recognise membership of <u>self-regulatory organisations</u> such as The Stock Exchange, the National Association of Security Dealers and Investment Managers, the Association of Futures Brokers and Dealers and the Insurance Brokers Registration Council as providing the authorisation required for an investment business.

ACCOUNTABILITY TO GOVERNMENT AND PARLIAMENT

The Government propose the following:

the Chairman and members of the Board or Boards will be appointed by the Secretary of State or with his agreement.

Board members will include users and other lay members as well as practitioners.

the Secretary of State will be entitled to withdraw regulatory authority if he considers that at any time a Board ceases to conform to the criteria set out in the legislation.

a Board's rules and practices will be subject to initial and continuing scrutiny for anti-competitive elements; the Secretary of State will have power to require the amendment or withdrawal of rules after obtaining the advice of the Director General of Fair Trading.

the Secretary of State will have power to require the amendment or withdrawal of the rules of the Boards if they are contrary to the international obligations of the United Kingdom.

the Boards will report annually to the Secretary of State who will lay their reports before Parliament.

there will be provision for a new and independent tribunal, whose members will be appointed by the Secretary of State, to be the final determinant of any dispute about authorisation decisions or about penalties for breach of the rules.

#### UNIT TRUSTS

The present controls will be relaxed to allow a greater variety of unit trusts to be made available to the general public and more speculative arrangements to be offered (and promoted) to authorised businesses, and by them to those investors who have appropriate financial resources and experience.

INVESTMENT ADVICE AND THE MARKETING OF INVESTMENTS



Investment advisers, including those who market life assurance or units in unit trusts, will be subject to the conduct of business principles. They will be under a duty to disclose "relevant information" including any material interest they have in a recommendation - for example commissions or other reward which they might receive from other parties. This will enable investors to make more informed decisions.

Under the PF(I) Act it is already a criminal offence to make misleading, false, deceptive or reckless statements or forecasts about investments. The new legislation will extend this provision to cover acts or courses of conduct likely to defraud or deceive investors or potential investors.

#### PENSIONS

There will be a requirement to disclose comprehensive information about the way pension scheme assets are invested. Any investment manager or adviser involved in the administration of pension schemes as a business (ie other than simply as an employee) will require authorisation. On the regulation of personal pensions the intention is that these should be subject at least to the same safeguards as other forms of investment.

## ADVERTISEMENTS AND CIRCULARS

Only authorised investment businesses will have a statutory right to issue advertisements or circulars likely to lead to the sale or purchase of investments. 'Advertisements and circulars' will be defined to include all media. "Cold-calling" will not be banned for the sale of investment products where a cooling off period can be provided.

## PUBLIC ISSUES AND TAKE-OVERS

The legislation will provide that all public offers of securities, primary or secondary, including offers made on take-over bids, will be subject to the same statutory regime. All offers to the public will have to comply with requirements regarding their contents, unless specifically excepted. The minimum contents of prospectuses will be set out in regulations made by the Secretary of State.

If the securities market felt that it would be helpful, the Government would be willing to consider providing statutory backing for the City Panel on Take-overs and Mergers.

### INSIDER DEALING

The legislation will extend the insider dealing provisions of the Companies Act 1980 to cover all securities, including options and futures contracts based on them, and also to make enforcement more effective.

### ENFORCEMENT

The regulatory Board (or Boards) and its recognised self-regulatory organisations will be responsible for enforcing their respective rules. The Department of Trade and Industry and the prosecution authorities will be responsible for enforcing the criminal law. There will be provision for civil law remedies for loss due to breach of the criminal law or of rules of business conduct. Finally, to facilitate the enforcement of these civil law rights, the Government propose powers for the Secretary of State (which he could delegate) to seek injunctions and 'disgorgement orders' against businesses in breach of the criminal law, the rules of the Boards or those of recognised self-regulatory organisations.



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# Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

Mr M C McCarthy
Principal Private Secretary to the
Secretary of State for Trade and Industry
Department of Trade and Industry
1 Victoria Street
London SW1H OFT

28 January 1985

Dear Cadran,

### WHITE PAPER ON FINANCIAL SERVICES

The Chancellor was grateful for your Secretary of State's letter of 21 January, which reassured him on most of the points raised in his letter of 15 January.

The Chancellor is very concerned that in the event of the two supervisory bodies currently envisaged agreeing to coalesce into one, no further primary legislation would be needed to take account of the change. I understand from previous correspondence that there is no problem on this, but would be grateful for your categorical reassurance.

Secondly, it is not clear from paragraph 7 of your Secretary of State's letter that you do not in fact intend to legislate for 100 per cent compensation. Mr Tebbit may like to know that there is at present no statutory compensation for depositors and shareholders of building societies; the societies are pressing him to make the present 90 per cent voluntary scheme part of the statutory arrangements. Can you clarify this point?

I am copying this letter to Tim Flesher (No.10), the Private Secretaries to other Members of Cabinet, Henry Steel (Law Officer's Department), Murdo MacLean (PS/Chief Whip), Alex Galloway (Paymaster General's Office) and Richard Hatfield (Cabinet Office).

Jon ever lever.

MRS R LOMAX
Principal Private Secretary

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DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET LONDON SWIH OET

TELEPHONE DIRECT LINE 01-215 5422

Secretary of State for Trade and Industry

21 January 1985

The Rt Hon Nigel Lawson MP
Chancellor of the Exchequer
HM Treasury
Parliament Street
London SWI

D Nigel

FINANCIAL SERVICES WHITE PAPER

Thank you for your helpful letter of 15 January. I hope the comments which follow will allay your concerns.

- 2 Your first point concerned the inclusion of bank, building and friendly society deposits in the definition of investments (paragraph 4.3(3)). While I am bound to say that I am not wholly persuaded by your arguments, I understand the difficulties it clearly causes you and I am therefore prepared to drop it.
- 3 The trouble with deposits is that they are not at all easy to distinguish from fixed-interest securities. For instance, investments in building societies, which are in most respects the same as deposits in a bank, have been defined as securities for many years. The same applies to National Savings. Again, the return on a gilt is guaranteed as to principal if it is held to maturity, and preference shares and secured debentures are in a somewhat similar position. Defining deposits as investments seemed to us the natural way to achieve various ends which I am sure are not in question eg that a manager should be as accountable for the 10% of a portfolio which he puts on deposit as for the 90% which he invests in ordinary shares. However, to include them in the definition is not the only way; and Parliamentary Counsel will also have a view. Officials here will keep in touch with yours on how precisely the matter is to be dealt with in the legislation.
- 4 As regards paragraph 4.23, this now requires the relaxation on the circulation of information to be to people who are both sufficiently expert to understand the risks involved in less orthodox investments and with ample enough financial resources to take such risks.



- 5 On the Tribunal, all that is involved in principle is the re-naming of an existing contingent liability in PES for the PF(I) Act tribunal. There has been no recourse to this tribunal for many years. I hope that the Boards will so conduct their affairs that the number of cases referred to the new tribunal and thus its costs are minimal. You will appreciate that I cannot make any realistic estimate at the present stage, we will be continuing the provision in our PES.
- 6 I agree that we shall need to be in touch not only on supervision of financial conglomerates irrespective of the legislation but also on the relationships in the proposed new gilts market and on the definitional problems about money funds as appropriate. Our officials are already in touch on these issues.
- 7 As far as compensation is concerned (paragraph 7.2) my intention, as you say, is not to undercut the best on offer. (It is my understanding that you envisage the new building societies regime considerably enhancing their present compensation arrangements.)
- 8 I can confirm that, where listed issuers or applicants for official listings are concerned, the only limitation on abridged prospectuses is that the full one (strictly speaking "listing particulars") is available. This, as you say, flows from the Stock Exchange (Listing) Regulations.
- $9\,$  I am copying this letter to the Prime Minister, other Cabinet colleagues, the Attorney General, the Chief Whip, the Paymaster General and Sir Robert Armstrong.

NORMAN TEBBIT

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Secretary of State for Trade and Industry

The Earl of Gowrie Cabinet Office Great George Street London SW1

DEPARTMENT OF TRADE AND INDUSTRY

MOPA SENO

# 1-19 VICTORIA STREET

LONDON SWIH OET TELEPHONE DIRECT LINE 01-215 SWITCHBOARD 01-215 7877

2| January 1985

D\_ Smy.

FINANCIAL SERVICES WHITE PAPER

Many thanks for your letter of 15 January. You suggest that a possible compromise to meet concerns about Parliamentary accountability would be to subject a Board's rules to Ministerial approval. As far as my initial act of delegation to a Board is concerned I am glad to say that what you propose is already provided for in the White Paper. The criteria for delegation which will be part of the legislation are set out in paragraph 5.6 and refer to the proposed rules of the Boards. Paragraph 1.6 also sets this out in general terms. I am not proposing Ministerial approval for subsequent rule changes by the Boards once I have delegated my regulatory powers to them for the reasons I set out in my letter to Quintin Hailsham of 14 January.

- Similarly I am glad to say that your other proposal, for Parliamentary control of the acts delegation, is one I have already considered and accepted. It does not appear in the White Paper for tactical reasons; I do not want to commit my reserves before I have been able to get the measure of the opposition.
- I am copying this letter to the Prime Minister, other Cabinet colleagues, the Attorney General, the Chief Whip, the Paymaster General and Sir Robert Armstrong.

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FROM:

THE RT. HON. LORD HAILSHAM OF ST. MARYLEBONE, C.H., F.R.S., D.C.L.



House of Lords, SW1A 0PW

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05/11/

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17th January, 1985

The Right Honourable
Norman Tebbit, MP
Secretary of State for
Trade and Industry,
1 Victoria Street,
London,
SW1.

Your ref: JU776 Our ref: 193/480/01

My Sear Norman white Paper on Financial Services

Thank you for your letter of 14th January in reply to mine of 1th January. I have also read with interest the Prime Minister's views expressed in her Private Secretary's letter, and in addition I have seen the views of Nigel Lawson and Grey Gowrie.

I fully recognise the importance which you and others attach to the setting up of a self-regulatory system. You are plainly well aware of the risks involved in this proposal, and I think you must be the ultimate arbiter of whether the risk is worth taking.

I am copying this letter to the Prime Minister, other Cabinet colleagues, the Attorney General, the Chief Whip, the Paymaster General and Sir Robert Armstrong.



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NOPH AT

# CABINET OFFICE

From the Chancellor of the Duchy of Lancaster

**Lord Gowrie** 

The Rt Hon Norman Tebbit MP Secretary of State for Trade and Industry 1 Victoria Street London SW1

MANAGEMENT AND PERSONNEL OFFICE Great George Street London SWIP 3AL Telephone 01-233 8610

15 January 1985

Dear Norman

FINANCIAL SERVICES WHITE PAPER

Thank you for copying to me your minute of 8 January to the Prime Minister seeking colleagues' approval of publication of this White Paper. I have seen the Lord Chancellor's letter of 9 January and your reply yesterday. I understand the difficult balance to be drawn in reconciling self-regulation and accountability to Parliament but I share the Lord Chancellor's concern that we shall be open to criticism for the relative lack of Parliamentary accountability envisaged in the White Paper proposals.

I am sure you will have considered the delicate balance between arrangements which will satisfy the City and arrangements which will be acceptable to both Houses of Parliament. I wonder though, whether there is a possible compromise in subjecting the rules governing the provision of financial services to Ministerial approval so as to confer accountability through Ministerial answerability to Parliament. This might appeal to Parliament as providing a reasonable safeguard while not threatening self-regulation. (There is a relevant precedent in the rules made by the new Council of Licensed Conveyancers under the Administration of Justice Bill.)

A further area where we may be vulnerable to criticism lies in the proposal that the Secretary of State should be able to delegate his regulatory powers to any (unspecified) body which seemed to him to meet criteria set out in the legislation. I understand your reasons for this. But I wonder whether we can expect Parliament to sign so open a

cheque. Perhaps it is worth seeing what reaction there is to this aspect of the White Paper proposals. But one way of taking the steam out of any criticism would be to give Parliament a role in the subsequent specific delegations by the use of negative or affirmative resolution procedure (on the model of S8 of the Transport Act 1982).

I am copying this letter to the Prime Minister, other Cabinet colleagues, the Attorney General, the Chief Whip, the Paymaster General and Sir Robert Armstrong.

Lour, e/rey

GOWRIE



BIC: J. LONG

### 10 DOWNING STREET

From the Private Secretary

15 January 1985

Den Caleur

# WHITE PAPER ON FINANCIAL SERVICES

The Prime Minister has seen your Secretary of State's minute of 8 January and the draft of the White Paper attached to it. She has also seen the Lord Chancellor's minute of 9 January and your Secretary of State's reply of 14 January.

The Prime Minister is generally content with the White Paper and, subject to the resolution of any points outstanding with colleagues, she is content that it should be published either next week or early in the following week.

She has considered the issues raised by the Lord Chancellor but believes that to adopt either of the courses he proposes would be inconsistent with the objective of creating a self-regulatory system. She also feels that the safeguards suggested provide an adequate degree of accountability to Parliament.

I am copying this letter to the Private Secretaries to members of the Cabinet, to Murdo Maclean (Chief Whip's Office), to Alex Galloway (Office of the Paymaster General) and to Richard Hatfield (Cabinet Office).

ANDREW TURNBULL

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Callum McCarthy, Esq., Department of Trade and Industry.



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# DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET

LONDON SWIH OET

TELEPHONE DIRECT LINE 01-215
SWITCHBOARD 01-215 7877

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JU789 Secretary of State for Trade and Industry

15 January 1985

Timothy Flesher Esq Private Secretary to the Prime Minister 10 Downing Street London SW1

Down Timothy,

### FINANCIAL SERVICES

The minute which my Secretary of State sent to the Prime Minister on 7 December promised a separate response on two points in your letter of 14 November to Ruth Thompson: delegation of supervision of the marketing of life insurance and unit trusts and the arrangements for dealing in equities and gilts after 1986. I apologise for the delay in covering these points.

### Life Insurance and Unit Trusts

- 2 As proposed in the White Paper, the DTI will shed its work on supervising the marketing of life insurance and unit trusts. The timetable for doing this will be set by the timetable for the primary and secondary legislation required before the Secretary of State can delegate his functions to the supervisory bodies. Our present best estimate is that this could be done early in 1987, but it is worth bearing in mind that we are dealing with quite complex legislation.
- 3 The DTI expect to pass supervision of unit trust managers and unit trust dealers to the new bodies, thus ending our present direct supervision. As for life insurance, we propose to delegate to the "Marketing of Investment Board" powers on advertisements, disclosure of certain facts by intermediaries and cooling off periods parallel to those in Part 3 of the Insurance Companies Act 1982 thus absolving the Department from direct action.
- 4 The DTI will retain responsibility for the prudential supervision of insurance companies. My Secretary of State would like to devolve this responsibility to the new practitioner-based bodies but there are EC difficulties. The EC Directive on life assurance, adopted in 1979, requires the supervisory authorities implementing the provisions of the Directive in the Community to



be official bodies. The Directive contains no provisions about marketing, which is why we are not barred from delegating supervisory responsibilities in that area.

# Equities and Gilts

- 5 The target date for the start of the new Stock Exchange dealing and settlement system for equities remains October 1986, three months ahead of the deadline agreed between the Government and the Stock Exchange in July 1983 for the abolition of fixed dealing commissions. The whole package of proposals, including changes in the membership rules, is to be put to an Extraordinary General Meeting of the Members in March of this year.
- 6 The screen-based electronic systems, which are to show market-makers' quotations and the price, size and time of the last trades, will cover all the most frequently traded securities possibly 1,000 out of a total of 2,350 listed equities. The remainder will be accommodated as the systems are enhanced. A computerised record of all trades will be matched against time quotations to allow policing of the "best execution" rule and market practices.
- 7 You asked for an account of the thinking underlying the Bank of England's consultation document on gilt dealing. The Bank have given you a note on this under cover of the Governor's Private Secretary letter of 7 January.
- 8 The Bank's paper gives the detail but you should note that the arrangements for disclosure will differ from those envisaged for equities in that there will be no "last trade tape". There was considerable discussion on this particular point between the Bank of England, the Chancellor of the Exchequer and our own Ministers. The Bank of England do not believe that the necessary liquidity of the gilts market can be achieved if information about gilts deals is disclosed on a "last trade" tape. All agreed that the gilts market did require different arrangements and that adequate disclosure to safeguard competition and investor protection needs should still be available.
- 9 I am sending copies of this letter to David Peretz (Treasury), John Bartlett (Bank of England) and Richard Hatfield (Cabinet Office).

Yours sincerely Maurean bodswork.

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Treasury Chambers, Parliament Street, SWIP 3AG 0(-233-3000

The Rt Hon Norman Tebbit MP
Secretary of State for Trade & Industry
Department of Trade & Industry
1 Victoria Street
London SW1H OET

15 January 1985

WHITE PAPER ON FINANCIAL SERVICES

Thank you for copying to me your minute to the Prime Minister of 8 January, in which you sought the approval of Cabinet colleagues to the publication of the White Paper.

Your proposals provide a bold and imaginative framework for an effective system of self-regulation. I am glad to see that the text takes full account of the concerns registered in my letter to you of 8 October 1984, and especially that you envisage that the Governing Councils of the new supervisory bodies will draw on a wide body of experience and expertise; that there will be a genuinely independent Appeals Tribunal, able to substitute its judgment for that of the bodies, and with Court powers; and that you envisage the possibility of there being only one supervisory body rather than two. I should have preferred a warmer reference to this possibility, but I understand your reasons for not wanting to tread too heavily.

I am content with the arrangements for appointment of the members of the Councils of the two bodies. I should, however, be grateful for your confirmation that in the event of the two bodies coalescing, no further primary legislation would be required to set in hand the new arrangements.

There is, however, one drafting point of which I should be grateful if you would take account before publication.

In 4.3(3) bank, and building society and friendly society deposits are included within the definition of investments, even though they are excluded from the coverage of the financial services legislation by paragraph 4.18. It would be better not to include them in the first place.



There is a significant and important difference between making an investment, where the investor has no guaranteed return of his capital from the person with whom he places his money, and making a deposit, where he does. There have always been great difficulties in arriving at a water-tight definition of deposit-taking, and hence in establishing enough evidence to make successful prosecutions for illegal deposit-taking under the Banking Act. I think it is confusing and unnecessary to include deposit-taking in your definition of "investments" since there is considerable practical benefit in maintaining a clear distinction between the two activities and the separate areas of supervision and legislation.

I know that the difficulty arises because of your - and my - desire to cover deposit-brokers as well as investment intermediaries. I would ideally have liked deposit-brokers to be brought into the new arrangements. The new advertising regulations, to be enacted shortly, should however go some way towards controlling their activities. If their coverage can only be achieved by inclusion of deposits in 4.3(3), we and the Bank would prefer to drop 4.3(3) and accept that deposit brokers would fall outside the scope of the new arrangements.

In paragraph 4.23 I wonder if the gullible rich are given enough protection against unscrupulous investment companies.

In paragraph 5.11, you describe the arrangements for the appeals tribunal. You propose that it should be financed from public funds. You give no indication of the likely scale of its activities or costs, and I quite see that an estimate would be difficult at this stage. I understand however that the new tribunal will subsume the functions of the existing Prevention of Fraud (Investments) appeals tribunal, and that the costs of the new tribunal can be met from your Department's existing PES provision.

I read with particular interest paragraphs 5.12 and 5.13 on the implications for supervision of the trend towards financial conglomerates. The financial services sector is clearly in the early stages of a transitional period of radical change, and we shall have to keep our supervisory arrangements under constant review, not only in the areas covered by your White Paper, but also in banking and building societies legislation. I shall certainly be considering the relationship between the Bank of England and the new supervisory bodies in the review of banking supervisory arrangements now in train.

In 5.15 and 5.16, I am content with the reference to the proposed new arrangements for the gilts market. But more work needs to be done in defining the precise relationship between the Bank of England, the new SIB, and the appeals tribunal. This is just one of the details to be settled during the present consultative period on the Bank's proposals.



On paragraph 7.12, I wonder whether it is wise to aim at 100 per cent compensation for private investors. I accept that you are not proposing such compensation against commercial risk; but even for "capital-certain" deposits in banks, building societies and licensed deposit-takers, the compensation available against fraud or insolvency is quite severely limited. Is it not wrong in principle to give no incentive to the investor to consider carefully the standing and reliability of the person to whom he entrusts his funds? I understand however that you do not intend to give 100 per cent statutory compensation, but that you do not wish to undermine existing best practice. On this basis I can agree the text.

Paragraph 9.10 refers to unit trusts investing in assets such as money market instruments. There are some definitional problems about money funds, and there remains some doubt as to the precise and desirable boundaries between the proposed financial services legislation and the Banking Act. I understand that our officials are considering these questions urgently.

On Chapter 13, I was concerned that the effect would be to make it virtually impossible for a company to make a public offering by use of the short prospectus procedure. I understand, however, that under the new listing regulations all listed companies will be free to make offers using the short prospectus procedure, both in initial flotations and in raising subsequent capital. If you can confirm that nothing in the White Paper prevents this, I am content with the drafting.

I am copying this letter to the Prime Minister and to  ${\tt Cabinet}$  colleagues.

NIGEL LAWSON

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1-19 VICTORIA STREET

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Secretary of State for Trade and Industry

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LONDON SWIH OET

TELEPHONE DIRECT LINE 01-215 5422 SWITCHBOARD 01-215 7877

January 1985

Lord Hailsham of St Marylebone PC CH FRS DL Lord Chancellor House of Lords SW1A OPW

My Dea Quinhin

WHITE PAPER ON FINANCIAL SERVICES

Thank you for your helpful letter of 9 January. I have indeed given much thought to the constitutional implications of my proposals. I acknowledged in my minute to the Prime Minister that the rule making powers which I will delegate to the Boards could attract Parliamentary criticism.

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Like you, I have been much concerned to avoid such criticism and following the same line of thought as you I considered the suggestions you outline. But I have concluded that to have LC, must insisted on either of them at this stage would have had two results. First the City would not have delivered selfregulation. We have repeatedly pushed the City hard on a number of issues, to the point where the Governor has expressed concern over whether he can deliver a self-regulatory system. I do not think I could press him further and I believe that either of the approaches suggested would have proved unacceptable. We would thus be left in regulatory terms either with a statutory commission or full-scale Departmental regulation. Second, we would have failed in our more general objective of distancing the Government from detailed regulation of industry and commerce. Apart from the political problems arising from such regulation we would risk slowing the speed of response of the regulatory system and making abuse and scandal the more likely. Whilst I agree that there will be those who will say we are being "soft" in the City and hard on the unions I think one could cheerfully offer a similar system for the regulation of trades unions to that which I propose for the City and have a good deal of fun in doing so! I believe the regulatory bodies will be accountable to Parliament since their powers are granted to them only whilst they command the confidence of the Secretary of State who is himself open to Parliamentary sanction.



I do not delude myself by thinking that we shall escape criticism. But we have thought our way to our conclusions balancing the risks and benefits of various approaches and I am ready to argue that the approach I propose to Parliament in the White Paper achieves a balance between the benefits of self-regulation and the proper level of accountability to Parliament to which you refer. I look to our supporters in Parliament to give their backing to these proposals.

I am copying this letter to the Prime Minister, other Cabinet colleagues, the Attorney General, the Chief Whip, the Paymaster General and Sir Robert Armstrong.

NORMAN TEBBIT



GB6LNAL HA





DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET LONDON SWIH OET

TELEPHONE DIRECT LINE 01-215 5422

SWITCHBOARD 01-215 7877

W January 1985

Secretary of State for Trade and Industry

CONFIDENTIAL

Richard Broadbent Esq Private Secretary to the Chief Secretary HM Treasury Whitehall SW1

Dear Richard

This is to confirm what we agreed on the telephone this afternoon, namely that my Secretary of State would not wish to press to make the announcement about the financial services White Paper on 22 January in view of the strong wish of the Chief Secretary to make an announcement himself that afternoon. We shall therefore be seeking an alternative date, either in that week or at the start of the week beginning 28 January.

I am copying this letter to Charles Marshall (Lord Privy Seal's Office), to Andrew Turnbull (No 10), and to Janet Lewis-Jones (Lord President's Office).

Comserver

M C McCARTHY Private Secretary

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cc: Mr. Redwood

PRIME MINISTER

### FINANCIAL SERVICES WHITE PAPER

Mr. Tebbit has circulated a draft of his White Paper on Financial Services. It now seems likely that it will be issued later than 22 January, thereby removing the threat of a clash with the Public Expenditure White Paper. Attached to his minute is a summary of the document - Flag A. John Redwood -Flag B - recommends that you endorse the White Paper.

The Lord Chancellor - Flag C - has minuted to express his concern about the principle of delegating rule-making powers to self-regulatory bodies. This point is not new and Mr. Tebbit's minute considers it in paragraphs 5 and 6. The difficulty is that to move in the direction sought by the Lord Chancellor would sacrifice much of the self-regulatory principle and would represent a move towards a statutory, SEC-type of regulation. Mr. Tebbit will be circulating a further note responding to the Lord Chancellor. Though you might like to look at these papers over the weekend, I suggest you do not respond formally to Mr. Tebbit until you have seen his reply to the Lord Chancellor.

11 January, 1985

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# FINANCIAL SERVICES WHITE PAPER

Norman Tebbit has chosen a careful course between setting up a highly regulated, Government controlled SEC, and relying on competitive markets, disclosure and contract law. His sensible compromise will be attacked from both sides.

SEC fans will say that the Government has no direct control over the self-regulatory bodies, and the self-regulatory bodies will not be tough enough in rooting out malfeasance. Norman has a good answer to this criticism: the bodies have to report to him, there is the criminal law to root out the worst offences, and the choice of self-regulatory agencies gives the system more flexibility to accommodate the everchanging shapes and patterns of investment business. A complex statutory regulation could simply drive business offshore and reduce London's importance.

There is a possible danger that the wide powers to vary or revoke the self-regulatory framework could be used later by less sensible politicians to usher in a much more heavy-handed approach without new law.

The case for caveat emptor, maximum disclosure and the rigours of competition which we have advanced, has been accommodated. For example, the suggestion that insurance

companies and brokers should reveal the level of commissions being paid to aid the marketing of their policies will be a great boon to the customer, who will doubtless be shocked when their level is revealed. This should also apply to self-employed pensions. Similarly, in the investment businesses, the need to declare to your client the investment business's own position in the stock concerned, and the price and time of the bargain compared with the then market price, will root out many of the current malpractices. Shady dealers can get away with a great deal in a world where they only have to send a simple contract note at the end of the day's business.

Making all of the businesses and bodies subject to competition law is also vital. Competition must have primacy over self-regulation, as it remains the most effective way of encouraging change and improving the deal for the customer. It is all too easy for self-regulatory bodies to degenerate into cosy clubs levying fees on their richer members in order to exclude the more vital and innovative small businesses. Norman will have to make sure that he can prevent this happening, by using the competition powers vigorously, and saying he will do so.

There are matters of detail still that need to be sorted out, but these may now be best left to emerge from the debate which the White Paper will launch. For example, there are difficulties in Section 7 concerning the rules governing own-account trading and trading for clients. Too tight a series of rules will mean that all the good deals are booked only to the investment business's own book.

The self-regulatory bodies may need powers to call for information from auditors, as the JMB Review Committee is now discussing in another field.

When considering, in Section 13, the market as a source of funds for companies and a method for restructuring companies and managements, we have to be careful that the new common régime does not delay raising money through routes like the vendor placing, or give too great an advantage to professional investors.

There may be troubles in the definition of investment businesses and in the wholesale registration of them, whatever limited rôle they may be fulfilling.

## Conclusion

These are all quibbles, and the White Paper is in some respects cautiously vague on the final form of legislation on these vital matters. You could give it a welcome as a good piece of work trying to chart a difficult course through hostile waters, and leave the rest to the debate which will follow publication.

JOHN REDWOOD



House of Lords, SW1A OPW

9 January 1985

My dear Norman:

White Paper on Financial Services

Thank you for copying to me your minute to the prime Minister seeking the approval of Cabinet colleagues to the publication of this White Paper.

I think you may have underestimated the criticism which will be mounted against your proposal that the legislation should enable you to delegate your regulatory powers to the proposed Securities and Investments Board and Marketing of Investments Board. To a limited extent, it is true that you would be able to require amendments to rules made by these Boards, and ultimately to revoke the powers delegated to them. But, if and so far as these powers remained delegated, the Boards would be law-making bodies without any sort of Parliamentary accountability. As you acknowledge, such sub-delegation to a quango is I believe unprecedented except, for instance, under the Emergency Powers (Defence) Act 1939. I fear this may cause a good deal of constitutional argument.

In paragraph 5.2 of the White Paper you list the anticipated advantages. But it does not seem to me that any of them would be prejudiced if you yourself made the rules on the advice of the Boards, or if the Boards made their rules as statutory instruments. Surely either course would preserve the advantages without dispensing with Parliamentary accountability. I realise, of course, that the Governor of the Bank and the City are to be their own masters. But there would surely be many who would point a contrast between this and our legislation on trade unions designed to increase Parliamentary control and accountability to their members.

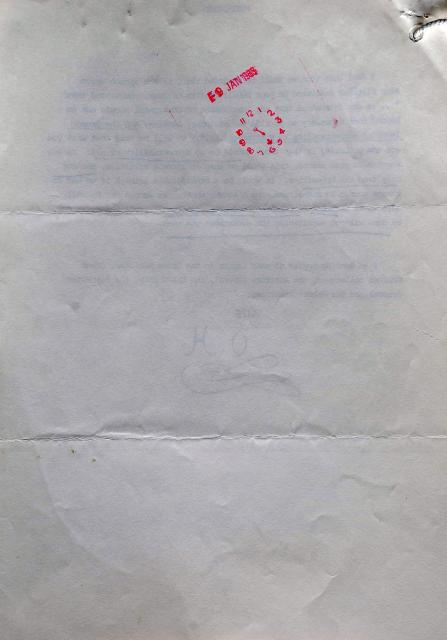
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The Right Honourable
Norman Tebbit MP
Secretary of State for Trade and Industry

I feel sure that we shall be reminded that, in the speech which Alex Fletcher delivered on your behalf on 17th October, you stated that "... we are determined that the involvement of Government should not go beyond that necessary to provide the statutory backing, and the proper level of accountability to Parliament, ...". It will be said that what you are now proposing is that there should be no accountability at all. As you suggest in your minute, this would be sure to attract criticism, and not only from the Opposition. It would be a considerable setback if we had to change course in mid-stream, and I wonder whether we should not be well advised to delete this aspect of the proposals now if, as I think, it can be done without sacrificing the advantages you seek.

I am sending copies of this letter to the Prime Minister, other Cabinet colleagues, the Attorney General, the Chief Whip, the Paymaster General and Sir Robert Armstrong.







Blf a Friday 11/1

PRIME MINISTER

## FINANCIAL SERVICES WHITE PAPER

I have already discussed with you and the Chancellor of the Exchequer our policy towards financial services which I plan to announce to the House as soon as possible, with my target date being 22 January. I have also taken the advice of the Attorney General on aspects of the institutional structure. My proposals have been drawn up in close consultation with the Governor of the Bank of England.

In order to promote the competitiveness of our financial services industry and to improve investor protection, my proposals involve a radical reform of the regulation of those in the City and elsewhere who undertake investment business. These proposals are described in the attached draft White Paper (a summary of the major points is also attached). They will be the basis of new legislation to be introduced in the 1985/86 Parliamentary Session. To meet my publication date, I would be glad to know by not later than noon on 15 January whether you and other Cabinet colleagues are content.

#### Objectives

The financial services sector is undergoing revolutionary change. A major impetus was our agreement with The Stock Exchange in 1983 to abolish minimum dealing commissions. Modern technology is also transforming the way in which business is conducted. International competition is increasing. My proposals are intended as an effective response to the challenge presented by the new circumstances.



When the House debated these issues last July, I stated my preference for regulatory safeguards to be provided through institutions financed and largely administered by the financial services industry itself, within the framework of a clear and simplified investment law. I also set out our objectives - efficiency, competitiveness, investor confidence and vigorous enforcement of the law. These were welcomed by the House and more generally in the City. They form the basis of the White Paper proposals.

#### Institutions

- The institutional arrangements described in the White Paper have been developed from the recommendations of the industry itself. The Governor proposed that regulation of business involved in investments and securities should be entrusted to a new body set up by and composed of practitioners, users of financial services and other lay members; the life assurance and unit trust industries proposed a corresponding body to regulate the marketing of such pre-packaged investments. Alex Fletcher announced our acceptance of the proposed institutional arrangements in a speech made on my behalf on 17 October. The bodies are now being established.
- Provided that Parliament enacts the legislative proposals to enable me to do so, I shall delegate my regulatory powers to these bodies. The bodies, which may well become a single body if the practitioners conclude this would be more effective, would be subject to statutory safeguards against the abuse of these powers. I will have considerable powers to appoint and dismiss the chairmen and members. Their decisions on authorisations and sanctions will be subject to adjudication by an independent tribunal



which I will appoint. Further safeguards would be provided by my right, on the advice of the Director General of Fair Trading, to revoke or amend rules which have anti-competitive effects. There will be a power to require rule changes to meet our international obligations. The Boards will report to me annually and I will lay their reports before Parliament. In other respects regulatory authority will reside with the bodies subject, of course, to my power to withdraw my delegation of authority in whole or in part if I am not satisfied by their performance.

The Attorney General has advised me that, while he does not think that there is any genuine constitutional principle at stake, the rule-making powers could attract Parliamentary criticism and resentment. But I believe that the advantages of placing the main regulatory responsibility on practitioner based bodies are adequately counter-balanced by the safeguarding provisions which I have set out above and that criticism can be effectively refuted.

#### Legal Aspects

- The new legislation will set out a wide definition of investments in order to deal with the inadequacies of the existing, and out-dated, Prevention of Fraud (Investments)

  Act 1958. It will also define an investment business anyone carrying on such a business will have to be authorised to do so. That is the task I propose delegating to the new bodies (or body).
- 8 A new set of regulatory principles which are intended to govern the conduct of all investment business will be in the legislation and will be the basis of the rules to be applied by the bodies authorising investment businesses. These are



derived from our Licensed Dealers (Conduct of Business) Rules 1983, but take account of the need to provide for protection against abuses of conflicts of interest in investment businesses.

- Better disclosure of relevant information will be relired; (eg for share offers, take-overs, life insurance and unit trust brokers' commissions). This will allow investors to make more informed decisions on their own supplanting the need for much regulatory "nannying". Disclosure of commissions paid to intermediaries by life insurance companies and unit trusts is an approach more consistent with our general philosophy than the statutory control over levels of commissions agreements which some parts of the insurance industry advocate.
- 10 My proposals do not create new criminal offences, but they significantly re-draw the boundaries of existing offences. Remedies will also be available to investors under civil law. Other matters include:
  - (i) proposals to tighten up on advertising calculated to defraud investors;
  - (ii) proposals to limit the marketing of life assurance by companies not based in this country or elsewhere in the European Community;
  - (iii) amendments to existing insider dealing legislation to make it more effective.

#### Conclusion

ll It is inherent in a practitioner-based system that many



derived from our Licensed Dealers (Conduct of Business) Rules 1983, but take account of the need to provide for protection against abuses of conflicts of interest in investment businesses.

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#### Conclusion

ll It is inherent in a practitioner-based system that many



of the detailed rules remain to be formulated, by bodies which do not yet exist. Subject to these caveats, I want the White Paper to be as firm as possible, setting out our plans rather than being yet a further piece of consultation. That said, I accept that some of my proposals may need to be modified in the light of public and Parliamentary reaction to them, as well as the work of the practitioners. It is on this basis that I commend the White Paper to my colleagues.

12 I am sending copies of this minute and attachments to all members of the Cabinet, to the Chief Whip, to the Paymaster General and to Robert Armstrong.

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§ January 1985

Department of Trade and Industry

SUMMARY OF WHITE PAPER ON FINANCIAL SERVICES (to be included as Chapter 16 of the White Paper)

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## The Main Proposals

- The Government propose new legislation on financial services in the United Kingdom. The main elements will be as follows:
  - (i) a new regulatory system for investment business
     to replace the Prevention of Fraud
    (Investments) Act 1958 (PF(I) Act);
- (ii) \_\_\_ deregulation of unit trusts;
- (iii) new standards for the marketing of "pre-packaged" life assurance and unit trusts and other "pre-packaged" investments;
  - (iv) provisions to regulate businesses involved in the administration of pension schemes;
    - (v) provisions governing the issuing of advertisements and circulars about investments;
- (vi) provisions to require the issue of a prospectus for all public offers of investments specifically excepted;
- (vii) provisions to revise and extend the insider dealing provisions of the Companies Act 1980;
- (viii) provisions to <u>outlaw acts calculated to defraud</u> or deceive investors.

## The Regulatory System

- 16.2 This will have four main elements:
- (i) a definition of "investments", which will include, for example, in addition to securities already covered by the PF(I) Act, financial and commodity futures and options. Life assurance will remain subject to the requirements of the Insurance Companies Act 1982 but marketing of life assurance contracts will be treated as far as possible in a similar way to that of other investments. The definition will exclude property which passes under the direct physical control of the investor if purchased.
- (ii) a definition of "investment business" which will include, for example, investment dealing, management, and marketing. Investment advisers will also be included. Financial journalists,

and those who publish analytical information without making recommendations (eg Extel cards) will not.

- (iii) provisions making it an offence to carry on investment business as defined without authorisation.
- (iv) provisions giving the Secretary of State
  authority which he will be empowered to
  delegate to a regulatory body which appears to
  him to satisfy criteria laid down by the
  legislation to grant, vary, make subject to
  conditions, suspend or revoke such authorisation
  and to lay down requirements for the conduct of
  business by those authorised.

#### Institutional Structure

- The legislation will permit the Secretary of State to delegate his powers in whole or in part. The City and the life assurance and unit trust industries have recommended that delegation should be split between two practitioner-based regulatory bodies, which would be created by the industry:
  - (i) a 'securities and investments board";
  - (ii) a 'marketing of investments board", covering in particular life assurance and unit trusts.

However, the legislation will in no way prevent delegation to a  $\frac{\text{single practitioner-based}}{\text{regulatory body.}}$ 

There will be provision for existing self-regulatory organisations such as The Stock Exchange, the National Association of Security Dealers and Investment Managers, the Association of Futures Brokers and Dealers and the Insurance Brokers Registration Council to continue to regulate their members if their rules are acceptable to the regulatory board, or boards.

<u>Criteria</u> for Delegation by the Secretary of <u>State</u>

- 16.5 The main criteria for delegation will be:
- (i) that the body's proposed rules are such as to ensure that those authorised by it are and continue to be "fit and proper" to carry on

investment business;

- (ii) that its proposed conduct of business rules afford adequate protection to investors, and are consistent with basic principles set out in the legislation (covering eg conflicts of interest, compensation and protection for clients' funds).
- (iii) that all these rules are no more restrictive of competition than is justified for the protection of investors.

#### Safeguards

- 16.6 The Government propose the following safeguards:
  - (i) no board member can be appointed without the Secretary of State's agreement.
- (ii) Board members will include users as well as practitioners.
- (iii) the Secretary of State will be entitled to withdraw regulatory authority in whole or in part if he considers that at any time a Board ceases to conform to the criteria set out in the legislation.
- (iv) a board's rules and practices will be subject to initial and continuing scrutiny for anti-competitive elements; the Secretary of State will have power to revoke or amend rules after obtaining the Director General of Fair Trading's advice.
  - (v) the Secretary of State will retain power to require the revocation or amendment of the rules of the Boards if they are contrary to the United Kingdom's international obligations.
- (vi) there will be provision for an independent procedure before a new and independent body whose members will be appointed by the Secretary of State for determining disputes on authorisation and the application of sanctions by the Boards.

#### Unit Trusts

The present controls will be changed to allow a greater variety of unit trusts to be made available to the general public and more speculative arrangements to be offered

(and promoted) to authorised businesses, and by them to sufficiently expert investors.

# Investment Advice and the Marketing of Investments

- 16.8 Investment advisers including those who advise on life assurance or units in unit trusts will be subject to the same basic conduct of business principles as other investment businesses. They will be under a duty to disclose "relevant information" including any material interest they have in a recommendation for example commissions defined as any financial or other reward received from other parties. This will enable investors to make more informed decisions.
- 16.9 Under the PF(I) Act it is already a criminal offence to make misleading, false, deceptive or reckless statements or forecasts about investments. The new legislation will extend this provision to cover acts or courses of conduct calculated to defraud or deceive investors or potential investors.

#### Pension Schemes

Any investment manager or adviser involved in the administration of pension schemes as a business (ie other than simply as an employee) will require authorisation. No decisions have yet been taken on the regulation of personal pensions but the intention is that these should be subject at least to the same safeguards as other forms of investment.

## Advertisements and Circulars

Only authorised investment businesses will have a statutory right to issue advertisements or circulars likely to lead to the sale or purchase of investments. 'Advertisements and circulars' will be defined to include all forms of media. "Cold-calling" will not be banned for the sale of investment products for which a cooling off period can be provided.

## Public Offers and Take-overs

The legislation will provide that all public offers of securities, primary or secondary, and including offers made on take-over bids, will be subject to the same statutory regime. All

offers to the public will require a full prospectus, unless specifically excepted (eg Eurobond offers). The minimum contents of prospectuses will be set out in regulations made by the Secretary of State.

16.13 The Government is willing to provide statutory backing for a city code on take-overs and mergers if persuaded that this is necessary.

#### Insider Dealing

16.14 The legislation will extend the insider dealing provisions of the Companies Act 1980 to cover all securities, including options and futures contracts based on them, and also to make enforcement more effective.

#### Enforcement

The regulatory board (or boards) and its recognised self-regulatory organisations will be responsible for enforcing their respective rules. The Department of Trade and Industry and the prosecution authorities will be responsible for enforcing the criminal law. There will be provision for civil law remedies for loss due to breach of the criminal law or of the board's rules. Finally, to facilitate the enforcement of these civil law rights, the Government propose powers for the Secretary of State to seek injunctions and 'disgorgement orders' against businesses in breach of the criminal law or of rules of business conduct.



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CC Mr willoth

#### 10 DOWNING STREET

From the Private Secretary

12 December 1984

## Financial Services White Paper

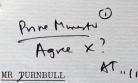
The Prime Minister has seen your Secretary of State's minute of 7 December and is content with the approach set out in it.

I am copying this letter to David Peretz (H M Treasury), Miss Janet Lewis-Jones (Lord President's Office) and Richard Hatfield (Cabinet Office).

Andrew Turnbull

Callum McCarthy Esq Department of Trade and Industry

CONFIDENTIAL



11 December 1984

#### FINANCIAL SERVICES WHITE PAPER

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The note from Norman Tebbit on the Financial Services White Paper is excellent, concentrating on:

- a. avoiding detailed regulation of the financial services sector;
- setting out a clear statutory framework and improving enforcement to deter fraud and malpractice;
- c. improving disclosure.

The exact number and nature of the City bodies should not be set down in the legislation, and the bodies should report annually to Parliament, through Norman Tebbit, on the exercise of their delegated powers. The power to appoint and dismiss the Chairman and members is the vital safeguard.

On the basis of Norman Tebbit's letter, you could welcome his general approach.

#### The draft White Paper

I have seen the 30 November draft, and have talked to Norman Tebbit and his private secretary, Callum McCarthy. They

agree that some of the original draft is in disagreement with the principles set out in his letter, or would be difficult to implement.

I have gone through it with them, and will now wait to see the revised draft White Paper before we can offer comments on it. I have also arranged to go and see Norman Tebbit himself on Wednesday, 19 December, to discuss it.

JOHN REDWOOD



#### CONFIDENTIAL

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PRIME MINISTER

#### FINANCIAL SERVICES WHITE PAPER

In my minutes of 12 July and 9 October I outlined my initial proposals on City regulation. You agreed these, subject to some points on the institutions (the correspondence rests with your Private Secretary's letter of 14 November). I am now writing to let you know the main features of the draft White Paper before circulating it to all Cabinet colleagues.

#### Objectives and Principles

My starting point is our agreed objectives - efficiency; competitiveness; investor confidence; and vigorous enforcement. The last of these is a matter for Government. The first three are best served by increasing the scope for market forces to operate. To this end, I do not advocate detailed regulation of the financial services sector by Instead, the White Paper will propose a clear statutory framework (to help with enforcement and deter fraud and malpractice), and will state general principles. these, practitioners in the market will be free to operate and compete, encouraged to innovate but also required to maintain high standards of conduct. I also plan measures to improve disclosure (see para 8), though we will not be seeking over-elaborate requirements that lead to the publication of worthless information.

#### Scope

3 The scope of the proposals will depend on how we define



investment. I intend to adopt a wide definition, encompassing almost all paper investments but excluding physical assets. I would take powers to bring new items within the definition by Order if need be. Likewise, the White Paper will define an investment business; and anyone carrying on such a business will have to be authorised to do so, as at present for securities.

#### City Bodies

With the exception of life assurance companies (where EC Directives require me to retain formal powers), this authorisation will be granted not by me, but by bodies - of which we propose there should initially be two - set up by the City, but to which I shall delegate necessary powers: one securities and investments; the other unit trusts and life insurance marketing. The legislation will not prescribe the number of supervisory bodies, so that there will be nothing to stop the two currently in prospect from being merged into one. I will only delegate powers of authorisation and supervision if I am satisfied that the bodies' proposed rules for investment businesses meet certain statutory requirements; and that the bodies have the resources to ensure that authorised investment businesses comply with them. To make enforcement easier, and to deter fraud and malpractice, the bodies will need specific powers to supervise and monitor the conduct of authorised investment businesses. These should include powers to require documents to be provided, and to impose sanctions, including the withdrawal of authorisation to carry on investment business. The bodies would in turn have the power to recognise a second tier of self-regulatory agencies, provided these met the necessary criteria: these could be existing organisations (like The Stock Exchange). No individual business would be



obliged to be part of one of these second-tier organisations: it could seek authorisation direct from the supervisory body.

5 The point of this practitioner-based approach is to provide adequate investor protection with the maximum freedom for market forces to operate. The Debate in July showed that some opinion on both sides of the House may raise constitutional objections to these proposals. The fact that I shall be delegating my statutory power for rule-making to a private sector body, not accountable to Parliament, may give particular cause for concern. But I am convinced that a new statutory body - the approach favoured by some - would not satisfy the objective of an efficient and competitive financial services sector. I believe Ministers would find themselves exposed in Parliament to questions arising between individual firms and their investors, in precisely the way you suggest we should avoid. We have a good case to make to Parliament on the accountability of the supervisory bodies: I will want them to report anually through me to Parliamennt on the exercise of their delegated powers; I will have considerable powers to appoint and dismiss the Chairmen and Members (see para 9); and further safeguards will include an independent procedure before a new and independent body whose members I shall appoint for determining disputes on authorisation and the application of rules, and my powers to revoke rules which are anti-competitive or contrary to international obligations (para 6). I shall discuss the question of accountability with the Attorney General.

#### Rule Changes

6 I believe the competitive aspects of the new regime merit special arrangements and particularly close supervision. The Director General of Fair Trading will advise me on the



bodies' rules, and I shall have powers to approve, revoke or amend rules which have anti-competitive effects, but only on the Director General's advice. He must propose, and I must dispose, to change a rule. This is right if I am to have a defence against PQs seeking me to challenge rules. I will also need to have powers to require rule changes to meet our international obligations. Otherwise, I believe the rule-making powers should reside with the supervisory bodies subject, of course, to my powers to withdraw my delegation of authority to them in whole or in part if I am not satisfied by their performance.

#### Legal Aspects

My proposals do not in fact create new criminal offences but they significantly re-draw and extend the boundaries of existing offences. In addition to the sanctions available to the supervisory bodies and the sanctions attached to breaches of the criminal law (which will be for Government to police), remedies will be available to investors under civil law for them to enforce if necessary through the courts. Other reforms include proposals to tighten up on advertising calculated to defraud investors, and amendments to existing insider dealing legislation to make it more effective. I hope that the new FIG arrangements and the results of Roskill will add to the enforcement armoury.

#### Disclosure

- 8 On disclosure I propose:
  - a) nearly all offers to the public will require a prospectus, which will have to be more informative than at present. Among other things this will

#### CONFIDENTIAL.



improve the quality of information made available in the fast growing over-the-counter market which is important to small firms and potential investors in them;

- b) the same requirements will apply to take-over documents;
- c) commissions paid to intermediaries by life insurance companies and unit trusts will have to be disclosed. This approach is more consistent with our general philosophy than statutory backing for commission agreements, which some parts of the insurance industry advocate.

#### Appointments

9 We are agreed that the formula for appointments needs to reassure Parliament about the accountability of these bodies, while giving the practitioners the confidence that they are not merely instruments of a state quango for which they will be expected to pay. For the securities and investments body, therefore, I propose to appoint the Chairman, with the agreement of the Governor; the Governor will formally appoint members, with my agreement. For the insurance and unit trusts body, I will appoint both the Chairman and members after appropriate consultation with the industry. In both cases, I shall have powers to dismiss the members.

#### Other Points

10 The White Paper is not intended as a consultative document. However, it is inherent in a practitioner-based system that many of the detailed rules remain to be

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formulated, by bodies which do not yet exist. Subject to these unavoidable caveats, I want the White Paper to be as firm as possible, setting out our decisions, rather than being a yet further piece of consultation. That said, I accept that some of my proposals may need to be modified in the light of public and Parliamentary reaction to them, as well as the work of the practitioners.

- 11 This minute covers most of the immediate concerns expressed in your Private Secretary's letter of 14 November. I shall arrange for you to have separate replies on the equity and gilts markets, and on delegating my Department's work supervising marketing of insurance and unit trusts.
- 12 Nigel Lawson has seen this minute and is content with it.
- 13 I am sending a copy of this minute to Nigel Lawson, Willie Whitelaw and Sir Robert Armstrong.

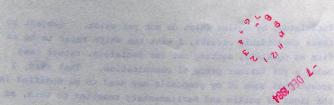
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N T

December 1984

Department of Trade and Industry

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21 November 1984

#### MR REDWOOD

#### FRAUD

I saw Ian Hay Davison at Lloyd's yesterday to ask him how the various cases in hand were proceeding. He said that the Lloyd's disciplinary procedures would be applied to Brooks and Dooley on 12 December 1984; Wigham Poland/Posgate on 14 January 1985; and thereafter would operate monthly to consider the "gang of four" (Grob etc), Wallrock of Minets and the PCW syndication.

Fraud investigations were in progress on PCW, the gang of four and the Multiguarantee case. In the first two, the Lloyd's disciplinary procedures were likely to precede any prosecution. So far as Multiguarantee was concerned, forgery was involved and the matter was in police hands. The operation, which was now in liquidation, involved the issue of a large number of extended warranties on goods which were falsely said to be insured with Lloyd's.

It seems to me likely that as news of disciplinary action by Lloyd's emerges at monthly intervals, together with the plans on City regulation, these frauds will get greater coverage. It is bound to be asked whether the DPP is doing

anything, and it would be desirable that at least one case should be seen to be progressing. Ian Davison thought Multiguarantee was the one more meriting early action.

DAVID HOBSON





#### 10 DOWNING STREET

From the Private Secretary

ce: Hut Lichan Meng Co

14 November, 1984

#### FINANCIAL SERVICES

The Prime Minister was grateful for your letter of 7 November. She has also seen Richard Stoate's letter of 22 October. She is broadly content with the line your Secretary of State is taking, subject to the following three comments.

First, she welcomes his assurances on the tightening up of the law on disclosing misleading or false information in prospectuses. But there is a distinction between stringent rules on misleading investors, and elaborate requirements leading to the publication of masses of useless information deterring smaller companies from capital issues.

The Prime Minister is still not entirely clear about the relationship which your Secretary of State envisages with the supervisory bodies. In her view, the role of the Government - and, indeed, the House of Commons - should be to satisfy themselves about the general conduct of City regulation. One possibility would be to require a full annual report from the supervisory body concerning the level of complaints, the number of problems that have arisen, and the future direction of its regulatory activity. But the Government should steer clear of involvement in individual cases, and should not be answerable for these in the House of Commons. She endorses your Secretary of State's view that he should have the power of appointing the key men to the supervisory bodies.

Thirdly, the Prime Minister still hopes that it will be possible in due course for the DTI to shed its work supervising marketing of insurance and unit trusts. She would be grateful for a possible timetable for delegating these activities to the new supervisory bodies.

The Prime Minister would also be grateful for a note from your Secretary of State on the progress of decisions on arrangements for dealing in equities and gilts after 1986, and the extent of disclosure to all market participants. Adequate disclosure is needed to create a fair and

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ompetitive market. She would be particularly interested in an account of the thinking underlying the Bank of England's consultation document on gilt dealing.

I am sending a copy of this letter to the recipients of yours.

(Timothy Flesher)

Miss R. Thompson, Department of Trade and Industry. 14 November 1984

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#### MR FLESHER

## FINANCIAL SERVICES

I attach a draft letter for you to send to DTI replying to their letter of 7 November.

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DAVID WILLETTS

DRAFT LETTER TO PRIVATE SECRETARY TO SECRETARY OF STATE,
DEPARTMENT OF TRADE AND INDUSTRY

#### FINANCIAL SERVICES

ZAMAAC

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MR TURNBULL

FINANCIAL SERVICES

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DTI on two matter, but cyree to put to tem the Play vanto punts on to DTI token men is attached

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The DTI letter of 7 November deals with the Prime Minister's questions on Mr Tebbit's investor protection proposals.

They are generally satisfactory, apart from the following 7/4 points.

#### Disclosure and the requirement to issue a full prospectus

The tightening up of the law on disclosing misleading or false information is sensible. But we don't want everyone having to issue 100-page US-style prospectuses to raise modest sums in the market. We need DTI's assurance that the more stringent rules on misleading investors - which we welcome - won't lead to requirements to publish masses of useless information.

Relationship between the Secretary of State and the Supervisory Bodies

There is still muddled thinking in this area. The Secretary of State should not come to the Despatch Box to answer questions about particular deals, companies or City problems, as a result of having become too close to the regulatory body.

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The rôle of the Government and the House of Commons should be to satisfy themselves about the general conduct of City regulation. They could require a full annual report from the supervisory body concerning the level of complaints, the number of problems that have arisen, and the future direction of its regulatory activity. This could spark a House of Commons debate on the subject of how good or bad City regulation is in the hands of the regulatory body. If public disquiet becomes great, then the Government would have the option of changing the terms of reference of the body, its personnel, or the regulatory arrangements.

This shows the importance of the Secretary of State appointing the key men. If the Governor appoints them, as he wishes, it will appear to be a cosy City arrangement. If the Prime Minister agrees, it might be worth recording her endorsement of Mr Tebbit's view in your reply.

#### Supervision of Insurance and Unit Trust Marketing

It would be a good idea for the DTI to shed its supervisory work as quickly as possible. It has been neither very popular nor very successful, and there would be some sense in treating it in a similar way to other types of market regulation. Mr Tebbit could be asked for a possible timetable for delegating these activities.

#### The Stock Exchange

Crucial decisions on the operation of the market after 1986 have been taken over the past few weeks:

- Details of deals in the top 200 equities will be revealed on a public tape within 90 seconds of the transaction.
- There will be more limited disclosure of transactions in thousands of smaller equities, because there may not be enough market-makers, and because adequate technology will not be in place.
- Gilts dealings will not be publicly revealed.

The Prime Minister could reasonably request a short note from Mr Tebbit on these decisions.

JOHN REDWOOD

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JU473 Secretary of State for Trade and Industry BIF Pu regponse

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# DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET

LONDON SWIH 0ET

TELEPHONE DIRECT LINE 01-215 5422 SWITCHBOARD 01-215 7877

7 November 1984

#### CONFIDENTIAL.

A Turnbull Esq Private Secretary to the Prime Minister 10 Downing Street London SW1

Dear Andrew,

FINANCIAL SERVICES

I am sorry not to have been able to reply sooner to your letter of  $\mathcal M$  October seeking clarification of five points arising from the Secretary of State's minute of 9 October to the Prime Minister.

These and other matters will be covered in the White Paper about which the Secretary of State will be consulting his colleagues in due course, but his present thinking on the five points raised by the Prime Minister is as follows.

## (i) Disclosure and the requirement to issue a full prospectus

It is indeed the intention to strengthen disclosure requirements. At present these apply only to public offers of securities. The proposal is both to amplify the requirements and to extend them to offers of other forms of investment. This should provide the public with significantly more information than they have to be given at the moment. Civil and criminal liability will attach to dishonesty, misrepresentation and omission in the prospectus document itself, but the authors of prospectuses will not be regulated as such.

## (ii) Roskill

Richard Stoate has answered this point in his letter to you of 22 October. The DTI hope that the Committee's report will appear as early as possible in 1985, in case we have to take account of particular recommendations in the proposed financial services legislation.

#### CONFIDENTIAL



## (iii) Competition policy and the Office of Fair Trading

The Secretary of State is determined that the regulatory bodies should not be, nor seen to be, cosy clubs or cartels. That would not be consistent with the Government's objectives of competitiveness and freedom of market forces. The intention is that the new legislation should make special provision for competition policy to apply to conduct in the financial services sector and to the rules governing that conduct. It would be for the Director General of Fair Trading to advise and for the Secretary of State (and not the Restrictive Practices Court) to decide the balance between competition and other factors including investor protection.

This proposal will not be welcome in all quarters. For example some Stock Exchange members may think that the agreement made with Mr Parkinson in July 1983 exempts them from competition policy. This is not the case. That agreement, implemented by the Restrictive Trade Practices (Stock Exchange) Act 1984, exempted the rules of the Stock Exchange only from the Restrictive Trade Practices Act 1976. Our forthcoming proposals will extend to all regulated financial services the exemption from that Act, but at the same time will impose equivalent competition surveillance through the Director General of Fair Trading.

# (iv) $\underline{\text{The relationship between the Secretary of State}}$ and the supervisory bodies

It is intended that the legislation would make it an offence to carry on investment business without prior authorisation just as it is now an offence to carry on the business of dealing in securities without that aurthorisation. Authority to grant, vary, suspend or revoke such authorisation, and to make rules for the conduct of business by those authorised, will be given in the first instance to the Secretary of State. He would be empowered to delegate this authority to a private sector non-statutory body meeting certain criteria, to be laid down in the legislation; and to withdraw it if at any time that body cease to conform to such criteria. Provided that the two practitioner-based bodies which the City proposes to create are set up in satisfactory form, the Secretary of State would in practice delegate these powers to them.

One of the conditions of delegation should be that these two bodies include users as well as practitioners. For the securities and investments body, my Secretary of State is strongly of the view that he should appoint the chairman of the body, after appropriate consultation with the Governor. The Secretary of State would also appoint to the insurance and unit trusts marketing body.



# (v) Supervision of marketing of insurance and unit trusts

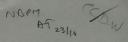
It is intended to delegate supervision of marketing after the legislation comes into force, provided that an appropriate body is formed which meets the statutory criteria. Further consideration is being given to the possibility of delegating the task of supervising unit trust schemes, and, at a later date, insurance supervisions. This could make more savings, but it is too early to form a firm view of just what the future arrangements will be.

I am sending copies of this letter to David Peretz (Treasury), Richard Stoate (Lord Chancellor's office), John Bartlett (Bank of England) and Richard Hatfield (Cabinet Office.

Yours ever

RUTH THOMPSON Private Secretary

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House of Lords, SW1A OPW

22nd October, 1984

Andrew Turnbull Esq., Private Secretary to The Right Honourable The Prime Minister, 10 Downing Street, London, SW1.

Dea Ardon

# Financial Services

Thank you for copying to me your letter of 1/th October 1984 to Callum McCarthy indicating a number of matters upon which the Prime Minister would find it helpful to have further clarification.

On point (ii) I understand that the Roskill Committee has now extended its deadline for the submission of evidence to the end of this month. As to the date when the Committee may report, I am sorry that we can do no better, at this stage, than to say that it will be some time during 1985.

I am copying this letter to Callum McCarthy (Trade and Industry), David Peretz (HM Treasury), John Bartlett (Bank of England) and to Richard Hatfield (Cabinet Office).

Paid:

Richard Stoate

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16 October 1984

PRIME MINISTER

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# FINANCIAL SERVICES

Tomorrow evening you are hosting a reception for the Conservative Industrial Fund and the City and Industrial Liaison Council. Your guests may be coming hot foot from a major City lunch at which Alex Fletcher will have announced the Government's proposals on City regulation. You might find it help to have a summary of what he will say.

A new body will be established to regulate the securities and investments industries, using the Stock Exchange, the National Association of Security Dealers and Investment Managers, and the Association of Futures Brokers and Dealers. A separate body will regulate the marketing of life insurance policies and unit trusts. Each will have statutory powers and responsibilities delegated by the Secretary of State. To ensure that these bodies do not become cosy cartels, there will be:

- an Independent Appeals Tribunal to resolve any dispute about registration of penalties;
- a remit for the Director-General of Fair Trading to scrutinise self-regulation for the Secretary of State, to ensure it is not anti-competitive.

It might be argued that the two separate supervisory bodies are unwieldy. But currently <u>dealing</u> in securities is rather different from <u>marketing</u> insurance and unit trusts. And if in future the two bodies want to merge, we would not rule that out.

The positive message to get over is that the new arrangements are consistent with the wider objectives of:

- keeping the City competitive;
- vigorous enforcement of the law;
- freedom for market forces to stimulate competition and innovation;
- the maximum reliable information for the investor.

Dound willetts





# 10 DOWNING STREET

From the Private Secretary

11 October, 1984

### SERVICES FINANCIAL SAVINGS

The Prime Minister has seen your Secretary of State's minute of 9 October. She is content with the general shape of the proposals which he has worked out in conjunction with the Chancellor of the Exchequer and the Governor of the Bank of England.

There are, however, a number of points on which it would be helpful for the Prime Minister to have further clarification.

- What action does your Secretary of State have in (i) mind to toughen up the law governing the issue of prospectuses and the provision of false and misleading information?
- (ii) The Prime Minister understands that Justice Roskill is considering the use of juries in fraud cases, and that 30 September was the deadline for evidence to his Inquiry. Is it known when he will be reporting?
- (iii) Is it intended to give the Office of Fair Trading a continuing remit to scrutinise the self-regulatory agencies to ensure that they do not relapse into cartels?
- (iv) What will be the relationship between your Secretary of State and the two main supervisory bodies? What powers will be delegated to them and who will appoint their members?
- Is it intended to transfer the supervision of the (V) marketing of insurance and unit trusts from DTI to the Investments Marketing Authority? Will this save any Civil Service posts in the Department?

I am copying this letter to David Peretz (HM Treasury), Richard Stoate (Lord Chancellor's Office), John Bartlett (Bank of England) and to Richard Hatfield (Cabinet Office).

(A. Turnbull)

C. McCarthy, Esq., Department of Trade & Industry

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10 October 1984

PRIME MINISTER

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Yesond

FINANCIAL SERVICES

I am afraid Mr Tebbit's minute of 9 October is not a very clear exposition of his investor protection proposals.

## What Mr Tebbit is proposing

(3)

Get rid of the Council for the Security Industries. Take
the three competent Self-Regulatory Agencies (SRAs) we
already have - the Stock Exchange, the National Association
of Security Dealers and Investment Managers, and the nascent
Association of Futures Brokers and Dealers. Give them the
job of day-to-day regulation. Set up an Investments and
Securities Authority (ISA) to check up on the regulators.
Although a private body, it would have legal responsibilities for regulation delegated to it by the Secretary of
State for Trade and Industry.

Do not go down the road of creating lots of new SRAs, as they might well prove feeble. So put the merchant banks, which currently have no regulatory agency of their own, directly under the ISA.

Apply a similar solution to the <u>marketing</u> of insurance and unit trusts. Again, there is an umbrella body - call this

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the Investments Marketing Authority (IMA) - which polices
the sellers of life assurance and unit trusts. If good SRAs
develop in this area, they will come under the IMA; and if
not, individual operations will be supervised directly.

#### Comment

As you know, John Redwood and I advocated an approach to investor protection resting almost entirely on competition, disclosure, and strict policing. But in July it was agreed in principle to move to some sort of self-regulatory model. Mr Tebbit's particular solution is ingenious. It uses existing bodies such as the Stock Exchange, but avoids artificially creating lots of new, feeble SRAs - the risk in the Gower approach. And his supervisory bodies can check up on the performance of SRAs, whilst acting as a lightning conductor for City scandals so they are not blamed on the Government. But before you sign up on Mr Tebbit's proposal, he needs to reassure you on five important points.

First, the law. The best way of protecting the customer is to give him clear legal redress which he can take on his own account, without going to any fancy regulatory body. I understand that Mr Tebbit is considering tightening up the disclosure law covering prospectuses. If a customer is sold an investment on the basis of false or misleading information, the contract is void and he can sue the

financial company direct. Mr Tebbit should give you an assurance that the law will be toughened up.

Secondly, one of our worries about SRAs was always that they would be become cosy cartels. The new boy with the good idea would be dismissed as the wide boy who wasn't a gentleman. Mr Tebbit is providing a clear right of appeal from the SRA to the supervisory body and, beyond that, to an independent tribunal. But in addition, the Office of Fair Trading should have an open remit to keep scrutinising all City self-regulation to ensure it is not anti-competitive.

Thirdly, we need to be much clearer about the relationship between Mr Tebbit and the main supervisory bodies. What sort of powers are going to be delegated from him to the supervisory bodies? Who is going to appoint them? Mr Tebbit needs to avoid being involved in day-to-day regulatory work, but at the same time have clear statutory powers to check that the umbrella body is not colluding in a cosy cartel.

Fourthly, the <u>DTI</u> currently supervises directly the marketing of insurance and unit trusts. Can this supervisory function be passed from the DTI to the Investments Marketing Authority? That would save some civil servants and avoid the DTI taking on a job which it probably isn't very good at.

Finally, a major difficulty in successfully prosecuting fraud cases - eg Lloyds Underwriters - is that they go before juries who are often incapable of understanding the technical financial points which come up. So the guilty escape. Judge Roskill is conducting an Inquiry into this, and 30 September was the deadline for evidence. When will he be reporting?

I recommend that you sign up on Mr Tebbit's proposal provided he is able to offer assurances on these points.

David Willetts



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#### CONFIDENTIAL

PRIME MINISTER

#### FINANCIAL SERVICES

I sent you a minute on 12 July about our new policy for financial services and set out the line I proposed to take in the July debate in the House. You replied on 16 July agreeing with my approach.

- 2 The House and the City generally welcomed the policy objectives I stated: competitiveness, enforcement and freedom for market forces to stimulate competition and innovation, allied to a regulatory framework aiming to provide effective protection for the investor.
- I have now concluded that, for the regulatory element in that policy, self-regulation within a new statutory framework is my preferred approach. To maintain the favourable momentum in City opinion (not least by allowing the Governor to get ahead with preparations which must be set in hand), and to give firm Government leadership, I think this should be publicly known ahead of issuing the full White Paper.



- I explained to the House my preference for institutions devised and largely administered by the financial services industry itself within the framework of a clear and simplified investment law. I welcomed the invitation by the Governor of the Bank of England to a group of senior City figures to advise him on the structure and operation of self-regulatory groupings which could be formed in the near future. I also referred to the similar group set up by Alex Fletcher to advise on parallel action concerning the marketing of life assurance and related products.
- I have now received the Governor's advice and discussed it with him. He has told me that he favours, and believes he can deliver, a single City body of practitioners, users and independent people with business experience to oversee the securities and investment industries. The insurance industry has proposed a similar single body to oversee the marketing of life insurance policies and unit trusts.
- 6 There is a fine balance to be struck here. I need to ensure that there is in fact self-regulation, with flexible response to changes in practice, which means that we must not as Government be too directly involved; at the



same time, if these two bodies are to be effective "self-regulators", they need statutory backing. I would be willing to give them that backing on condition that they satisfied basic principles of conduct to be laid down by Government e.g pattern of membership, constitution, competition, safeguards against conflicts of interest, protection for clients' funds. My plan therefore is to seek powers under new legislation which I would then delegate to these new bodies provided they meet the tests. As an additional safeguard against abuse, I would not want these bodies to have the final say on licensing and disciplinary questions; but to avoid involving myself in such matters I would require the bodies to have an independent tribunal whose members I would appoint. On this basis we should be able to harness the present - welcome - City impetus to achieve self-regulation to a measure of ultimate control and influence. I should also avoid being too closely involved in answering to Parliament. The legislation would be so drafted so as to ensure no obstacle to eventual amalgamation of these two bodies, if that were to be how they evolve.

7 I propose, and shall bring forward in due course, a White Paper. As well as being our major policy statement giving details of our plans for legislation and of these



institutional arrangements this White Paper will contain the Government's response to the recommendations made by Professor Gower in his report and to the resulting comments on it from a wide cross-section of City opinion. To give time to prepare an adequately comprehensive document, and to give colleagues time to consider it, I have in mind publication early in December.

- I have discussed with the Governor the danger that the currently favourable momentum in City opinion might be jeopardised if I give no further public indication of the Government's thinking before the White Paper is published. I am sure that it would maximise our chances without damaging the White Paper announcement if I stated publicly in the near future our decision to go for self regulation within a statutory framework as the preferred option and outlined how we see this developing on the lines of this minute. This would clear the way for further progress in establishing support for the City for the proposed arrangements and in implementing them.
- 9 I have discussed this with Nigel Lawson who is content.



10 I am copying this minute to Nigel Lawson, Quintin Hailsham, the Governor of the Bank of England and Sir Robert Armstrong.

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9 October 1984

(Approved by the Secretary of State and signed in his absence)

Department of Trade and Industry

# Ermph Don 89 Investor Pispectur





HOUSE OF LORDS. SW1A OPW



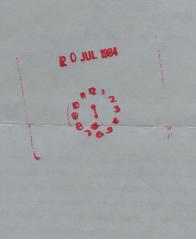
The Right Honourable Norman Tebbit MP Secretary of State for Trade & Industry 1-19 Victoria Street London S.W.1

Mydear Norman:

Financial Services: A New Policy

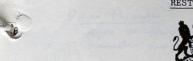
Thank you for sending me a copy of your letter of 9th July 1984 to Nigel Lawson. I note especially your concern to ensure tougher enforcement of a simplified and clear investment law to deter fraud and malpractice. As you know, a Committee has been set up under the Chairmanship of Lord Roskill to examine the question of the form of trial which commercial frauds ought to take.

I am copying this letter to the Prime Minister, the Chancellor of the Exchequer, the Governor of the Bank of England, the Attorney General and Sir Robert Armstrong.











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# 10 DOWNING STREET

From the Private Secretary

16 July 1984

# FINANCIAL SERVICES DEBATE

The Prime Minister has seen your Secretary of State's minute of 12 July and the note attached to it. She agrees with the approach he has worked out with the Chancellor and the Governor and welcomes the emphasis which is being given to disclosure of information, competition and law enforcement as the best way of protecting the investor. She believes SRAs should be presented as a supplement to this and should not be allowed to become anti-competitive cartels. She believes that your Secretary of State is right at this stage to keep an open mind on the establishment of a co-ordinating body for the SRAs.

I am copying this letter to David Peretz (HM Treasury), John Bartlett (Office of the Governor of the Bank of England) and Richard Hatfield (Cabinet Office),

Andrew Turnbull

Callum McCarthy, Esq., Department of Trade and Industry. 4

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Chanceless and Governor?

MR TURNBULL

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13 July 1984

FINANCIAL SERVICES DEBATE

In all

Mr Tebbit's letter of 12 July sets out his approach to investor protection. It is much closer to the Prime Minister's thinking than the earlier work done by the DTI. It emphasises that information, competition and tough criminal law are the best way of protecting the investor.

Mr Tebbit and the Chancellor both believe, however, that a few Self-Regulatory Agencies (SRAs) will also be needed. We remain sceptical. But at least Mr Tebbit emphasises that the SRAs will operate at arm's-length from Government and will be subject to competitive law to prevent their becoming cosy cartels. A lot will depend on how the SRAs operate: they must not be heavy-handed, and should not become mini-SECs.

We are opposed to any "umbrella body" (ie a quango) between the DTI and the SRAs. Mr Tebbit is open-minded on this.

We recommend that the Prime Minister agree to Mr Tebbit's broad approach. His speech on Monday should stress information, competition and law enforcement as the best way of protecting the investor. SRAs should be presented as supplements to this, and should not be heavy-handed cartels. Mr Tebbit should also avoid any commitment to establishing an umbrella body.



PRIME MINISTER

#### FINANCIAL SERVICES DEBATE

As you know we have a debate in the Commons on 16 July on financial services. You and colleagues will wish to know the line I propose to take in the debate.

- 2 I enclose a note which I discussed today with the Chancellor and the Governor of the Bank of England. (Your Policy Unit was represented at this discussion). The general lines of this note were agreed.
  - 3 In the debate I propose to give a general indication that our thinking goes in this direction. I shall confirm the intention to produce a White Paper later in the year. That will be the occasion for the definitive statement of Government policy. The purpose of Monday's debate is mainly to give the House an opportunity to express its views. I shall of course be consulting colleagues in due course on the White Paper itself.
  - 4 I am copying this minute to Cabinet colleagues and to Sir Robert Armstrong.

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/2 July 1984



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FINANCIAL SERVICES: A NEW POLICY

#### Background

- 1 The Government needs to take action now. A "financial services revolution", prompted by the reforms to improve Stock Exchange competitiveness, is rapidly altering the institutional structure of the City of London. There is increasing international competition in the provision of financial services.
- 2 The financial services sector in the UK and the investing public generally is looking to Government for an early indication of its attitude to these developments and for action. The Commons debate on financial services provides an opportunity for us to test Parliamentary opinion before issuing a White Paper in November and legislating in the 1985/86 session.
- 3 Dealing in securities is currently governed by the Prevention of Fraud (Investments) Act 1958 (PF(I)Act). Under the Act dealers in securities, unless exempted, require a licence from my Department. The Act, reflecting its 1939 origins, is widely acknowledged to be defective. A series of scandals in the securities and commodities industries highlighted the deficiencies in the present system and led to the appointment of Professor Gower in July 1981. His terms of reference required him to consider the statutory protection required by investors.
- 4 Part 1 of Professor Gower's Report, published in January, calls for investment business to be regulated by a system of self-regulatory agencies (SRAs) within a new statutory framework. He recommends that this system should apply not only to securities dealing but also to areas now unregulated such as dealing in commodities and the marketing of life assurance. A note on SRAs is at annex A.

#### Recent Developments

- 5 Since the Report was published there have been important developments:
- (i) the regroupings in the City have involved the takeover of jobbers, brokers and discount houses by clearing banks, merchant banks and finance houses. These have been mainly British with a few foreign firms also involved. These changes have created new challenges for those concerned with investor protection and customer confidence particularly on conflicts of interest;

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- (ii) more than 100 commentaries have been received on Gower's proposals, the great majority agreeing on the need for reform of the present legislation and method of enforcement;
- (iii)the Governor of the Bank of England has set up a group of senior City practitioners to advise him by the end of August on the structure and operations of selfregulatory groupings which could be set up in the near future. Neither the Governor nor the Government is bound by the Group's advice, but it will show whether the City can itself deliver a practical system of self-regulation to cope with current challenges; and
- (iv) to parallel the Government's initiative, Mr Fletcher has invited the insurance sector to consider making its own proposals for self-regulation, also by the end of August.

# Policy Objectives

- ${\tt b}$  . I see the following as our main policy objectives (in order of importance);
- (i) a financial services sector able to provide services to UK industry and commerce, private investors and the Government in the most efficient and cheapest way and which is internationally competitive;
- (ii) freedom for market forces to stimulate competition and encourage innovation;
- (iii) the regulatory framework must provide effective protection for the investor; it should not, however, be allowed to become a screen behind which the forces of protectionism go about their business undisturbed;
- (iv) the regulatory framework must inspire investor confidence by ensuring that the UK financial services sector both is and is clearly seen as, a competitive and "clean" place in which to do business: and
- (v) the regulatory framework must be both predictable enough to shape structural change in the City but sufficiently flexible neither to cramp this process not be overrun by it, and adaptable enough to meet the requirements of business between professionals.

In addition there are general Government targets:

(vi) the Government should not appear to take responsibility for the activities of City practitioners;

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- (vii) the minimum number of civil servants; and
- (viii) the minimum number of quangos.

#### A New Policy

7 There is a spectrum of policy ranging from "caveat emptor" on one end to close and detailed regulation of the financial services sector by Government at the other.

8 Philosophically I favour standing as close to reliance on market forces as we can defend politically. So I see a need for:

- (i) maximum disclosure of information;
- (ii) exposure of practitioners and their institutions to the full force of our competition policy; and
- (iii) tougher enforcement of a simplified and clear investment law to deter fraud and malpractice.
- 9 These three ingredients would go a long way towards meeting the policy objectives set out in paragraph 6 above. But alone they will not do enough to reinforce investor confidence. We need not only measures to detect fraud, and to punish it severely when it occurs, but also measures to make fraud less likely to occur; I see a small number of functional SRAs as providing this ingredient of prevention. This would also enable us to take advantage of the Governor's initiative to enlist the support of the providers of financial services themselves in making the market clean and competitive.
- 10 The Government would lay down a broad statutory framework. Within this, the SRAs would be voluntary, and we would look to practitioners to set up a small number of SRAs organised on a functional basis. Within the statutory framework they would set out and administer at arms-length from Government such detailed rules as are judged by them to be appropriate to the markets they are serving and the investors whose money they are handling. The SRAs would be made subject to existing competition policy so that they do not become "cosy" clubs. I believe that such an approach should be compatible with the European Community's approach to investor protection.
- 11 We may or may not have a co-ordinating body to assist the Government in its dealing with the SRAs. I leave that question open at the moment until I hear what the Governor's Group may have to say; the final number of SRAs established will have a

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bearing on this. Similarly I await the views of the Insurance Group but I consider that we need to treat life assurance marketing in a manner substantially equivalent to the marketing of other competing investments.

12 Developments over the next few months, including advice from the Governor's Group and the Insurance Group, will help us to refine the broad approach set out in paragraphs 7-10. I think it is practicable and that it meets the policy objectives I have set out.

Department of Trade and Industry

9 July 1984



#### SELF-REGULATORY AGENCIES

A self-regulatory agency ("SRA") would have the following main characteristics:

- (i) Registration requirements ensuring that those carrying on investment business are fit and proper persons (by virtue of checks on possible criminal records, training, financial resources, etc.).
- (ii) Rules relating to the conduct of business by those it supervises which afford adequate protection for investors including provision for separate client accounts, where relevant, compensation, disclosure of commissions, disclosure of interest in transactions for clients, and the provision that in any conflict of interest the client's interest shall be paramount.
- (iii) Effective procedures to monitor and enforce observance of those rules and to investigate complaints.
- (iv) A governing body adequately independent of the sectional interests of the SRA's members.
- 2 It would be an offence to carry on investment business unless registered either through membership of a self-regulatory agency ("SRA") recognised by Government or, if necessary, directly with Government.

#### Current Position

- 3 The PF(I) Act already provides for some delegation of prior authorisation by the Secretary of State to "recognised bodies" admission to which makes it unnecessary to be licensed by the DTI.
- At present there are nine "recognised bodies", of which the following have many of the characteristics of SRAs: The Stock Exchange, The National Association of Security Dealers and Investment Managers (NASDIM), The London International Financial Futures Exchange (LIFFE). The SRA concept has thus been shown to be viable in practice. Several respondents to Gower have expressed their readiness to form or become SRAs.

## Future Policy

5 If the self-regulatory route is adopted, the following basic principles commend themselves (and have emerged from many of the commentaries on Gower):



- the number of SRAs should be limited (otherwise they are unlikely to be effective or comprehensible to the investing public);
- the coverage of SRAs should be "functional", and not necessarily derive from existing trade associations (to emphasise their supervisory role and prevent capture by sectional trade interests);
- the rules of each SRA should be consistent in ensuring an appropriate level of investor protection;
- their rule-books and constitutions need to be scrutinised by the DTI and opened to the full effect of competition policy.
- 6 'Given that SRAs are voluntarily set up by practitioners, there can be no guarantee that SRAs can or will be set up readily in all the areas where they do not at present exist. But we would expect there to be a need for not less than four SRAs. The simplest groupings could be as follows:

Possible SRAs: - Existing bodies:

1 Dealing and market-making in The Stock Exchange securities Merchant Banks

Merchant Banks Clearing Banks The security dealers in NASDIM

2 Investment management and advice Unit trusts, and other portfolio managers

3 Dealing in and marketing of Dealers and brokers in commodities and futures futures I IFFF

4 Marketing of collective Insurance and unit investments and insurance trust salesmen, brokers and dealers

7 It would be for the DTI to supervise the SRAs unless an umbrella body was set up to monitor and co-ordinate their activities.

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A BRIEF FOR THE DEBATE ON THE GOWER REPORT ON THE REVIEW OF INVESTOR PROTECTION IN THE FINANCIAL SERVICES SECTOR

> HOUSE OF COMMONS MONDAY, 16TH JULY 1984

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The Gower Report on the Review of Investor Protection in the Financial Services Sector

# Introduction

The rapid developments that are now taking place in the markets for financial services have made it necessary to construct a regulatory system which both allows the City to respond successfully to increased international competition but which at the same time affords sensible protection to the investor. These two objectives come together in that a market in which an investor has the confidence to invest, will also be a more competitive market internationally.

In July 1981, the then Secretary of State for Trade commissioned Professor Gower to examine the statutory protection required by private and business investors and to assess the need for statutory control of dealers in securities, investment consultants and investment managers and to advise on the need for new legislation. Professor Gower consulted extensively and received views offered in response to a Discussion Document issued in January 1982. His final report was presented to Parliament in January 1984.

Mr Alexander Fletcher, pointed to the wider significance of creating a system that had the confidence of the investor when he spoke of the need to spread:

'understanding of investment and the City to the Community at large - to the many people who could afford to invest but are deterred by social prejudices or ignorance of the processes involved: people who at present have no easy access to the market place. This is the real challenge to the securities industry. Wider share ownership is not just about small investors dealing on the Stock Exchange. It is also about promoting a greater understanding of how wealth is created, how 'stocks and shares' are linked with productive capacity, earnings and employment' (Society of Investment Analysts, 16th February 1984).

#### Need for Reform

The existing legislation on which investor protection is based are the <u>Prevention of Fraud (Investments) Act 1958</u> and the <u>Companies Acts</u>. However, the rapid changes that are now taking place in the <u>City and the incidence of fraud has made a review necessary</u>.

DEVELOPMENTS IN THE CITY: Plans for self-reform by the Stock Exchange in the face of changes in the international securities markets have provided much of the stimulus for further change.

In July 1983 the Government announced its intention to exempt certain agreements relating to the Stock Exchange from the Restrictive Trade Practices Act 1976, in return for promises of self-reform that would see a gradual abandonment of minimum commission scales by the end of 1986. In November 1983 Sir Nicholas Goodison, Chairman of the Stock Exchange set up two committees; one to consider the methods of dealing and market making, the other to review the constitution and membership structure of the Exchange. On 12th April 1984 the product of their deliberations, 'The Stock Exchange. A Discussion Paper', was published. Among the important changes that have already been implemented, together with the ideas for reform contained in the Paper, include:

 The present system of single capacity, seperating the functions of stockbroking and stockjobbing could not last, following the introduction of negotiated commission.

- The elimination of minimum commissions on bargains in overseas securities, and firm plans for eliminating minimum commission altogether.
- A relaxation of the restrictions on membership and the establishment of international dealerships.
- The introduction of lay members on to the Council.
- Plans to improve the quality and quantity of publicly available information on trades. e.g. Development of the Stock Exchange Daily Official List, to provide a better public record of business done.
- Recognition that expenditure would be required to ensure that there was adequate supporting technical systems (i.e. market information and settlement systems).

These developments, following the agreement between the Government and the Stock Exchange, offer significant indications as to the way in which essentially self-regulated systems can develop without the requriement for direct Government supervision and control. As Sir Gordon Borrie, Director-General of the Office of Fair Trading has said:

'The deal at the time didn't seem very satisfactory, because the Stock Exchange gave up only one restriction. But later the City started doing a whole number of things that are going to create competition for the benefit of users and investors and create more competition between the British and world financial markets' (Daily Telegraph, 9th April 1984).

Other important developments have been the creation of an Association of Future Brokers and Dealers (AFBD) and the revision of the constitution and rules of the National Association of Securities Dealers and Investment Managers (NASDIM). Similarly, the difficulties in the insurance industry provoked the then Department of Trade to undertake investigations into the affairs of the Alexander-Howden Group and Minet Holdings and found Lloyds of London involved in litigation with one of its underwriters, Mr Ian Posgate; since that time and the appointment of Mr Ian Hay Davison as the first chief executive of the insurance market, wide ranging reforms for improving the self-regulatory mechanisms have been set in train including proposals for new rules and regulations designed to reveal commercial relationships between working members of Lloyds and companies with which they do business.

These changes have been taking place against a background of increasing international competition; the scrapping of fixed commissions on the New York stock market, the march of technology and the consequent development of 24 hour markets have acted as a catalyst for restructuring in London.

Stock Market firms have linked up with other financial institutions. Barclays, for instance, has established a pairing with both a jobber, Wedd Durlacher and a broker, de Zoete and Bevan. This is illustrative of a trend for more broadly based financial 'supermarkets' which are perhaps best highlighted by the merger between Hambro Life and Charterhouse J Rothchild.

#### As the Economist has pointed out:

'In the past six months, five British merchant banks and clearers have pounced on some of London's biggest jobbers and brokers; a city money broker is opening a new stockbroking firm, the first for eight years; a Scottish investment trust has taken a stake in an Edinburgh broker; and a life assurance office has recently increased its stake in a merchant bank to just under 30 per cent' (12th May 1984).

# Objectives of Reform

The purpose of this debate is to hear the views of the House on the subject of investor protection; the Government has made no hard decisions on the form that the new system of regulation should take. But whatever structure is developed must strike a balance between over-regulation, where the financial markets are unable to respond quickly enough to keep pace with the changing requirements of investors, and a form of self-regulation where the regulators look after the interests of their own members at the expense of the investor. The Financial Times has characterised the two extremes as 'caveat emptor versus the nanny society' (30th April 1984). The Gower Report itself outlines the basic philospohy as being one where the regulation in the interests of investor protection 'should be no greater than is necessary to protect reasonable people from being made fools of' (Cmnd 9125). This tacitly acknowledges that overprotection can be just as harmful to the investor by encouraging him to be less careful with whom he deals.

Mr Norman Tebbit, in a speech to the Touche Remnant International Advisory Board's conference in London on 26th June listed five main objectives in the Government's approach to the changes taking place in the City. They were:

- a financial services sector able to provide services to British industry and commerce, private investors and Government in the most cost-effective and internationally competitive way.
- freedom for market forces to stimulate competition and encourage innovation.
- a regulatory framework which provides effective protection for the investor, but not in such a way that it fails to respond to international developments and thereby becomes a screen for protectionism.
- a regulatory framework which inspires investor confidence by ensuring that the British financial services sector is both a competitive and 'clean' place in which to do business; and is clearly seen as such.
- a regulatory framework which is predictable enough to shape the structural changes in the City which are now gathering pace, but also sufficiently flexible neither to cramp this process nor to be overrun by it.

Mr Tebbit has summarised the position thus:

'Investors simply will not risk their capital in markets which are not adequately supervised. Nor will they be able to operate quickly and effectively if they are excessively supervised' (Financial Times, 15th May 1984).

# The Gower Report

THE REGULATORY SYSTEM: initially proposed by Gower in the Discussion Document was a self-regulatory system carried out by three or four functionally based agencies covering the main financial activities i.e. securities, commodities and futures, investment managers and advisers and insurance salesmen and advisers. The final Report, however, envisages a larger number of self-regulatory agencies (SRAs) based largely on existing professional groupings.

However, the Report recognises that this is not an ideal situation. It states that:

'It is regrettable since I have no doubt that senior officials from central banks and supervisory authorities in eleven countries were right in concluding, at a conference held by the Bank of England in May 1983, that: "because distinctions between types of financial institutions are becoming blurred supervision should be based on functional rather than institutional criteria ...' (Cmnd 9125).

The great advantage of fewer, but larger functionally based SRAs is that they would command more resources and therefore be able to exercise more effective control. In addition functional agencies would be less likely to be dominated by their own members, as purely professional bodies.

The Report recommends that SRAs should receive recognition only if they satisfy certain criteria, notably: the fairness of membership rules; strict regulations relating to admission that ensures that members are fit by virtue of character, training, experience and financial resources to trade; strict rules of conduct, i.e concerning conflicts of interest, disclosure of all sources of remuneration, recommendations or advice that are unsupported by evidence; adequate safeguards for clients in the event of the collapse of those carrying out investment business; and adequate procedures and resources to effectively monitor and enforce the observance of its rules. These rules would be drawn up in such a way as to make one particular agency competent to regulate firms whose activities crossed functional boundaries.

The form of supervision of these agencies is, according to the Report, a straight choice between the Department of Trade and Industry (DTI) and a new self-standing Commission. The Report points out that the Council for the Securities Industry (CSI) would have an important role in the absence of a Commission, to assist the DTI in the 'recognition and surveillance of those agencies' (Ibid).

The statutory authority would, however, have the ultimate responsibility for recognising SRAs and ensuring that their business was properly conducted. It would also have a function to register directly, those firms that were not covered by an SRA.

The Report recommends that, initially the statutory body should be the Department, but that if, once legislation has been introduced, it is found that the day to day volume of Governmental regulation and supervision had become substantial, a self-standing commission answerable to the Secretary of State should be established.

As a review of the Gower Report by Arthur Young McClelland Moores and Co. has said:

'In essence, the Report is proposing that, within a statutory controlled environment self-regulation, which operates well in some areas, but not so disciplined at present in others, should be given a chance to prove that it can do the job effectively - if it fails, the statutory body is the only alternative' (Review Number 51, January 1984).

SCOPE OF REGULATION. The Report recommends that in principle a new Investor Protection Act should cover all marketing activities (including investment advice) relating not only to 'securities' but also to other investments such as those in commodity or financial futures, pooling arrangments or contracts linked to life insurance, but not in physical objects over which the investor will secure exclusive control after acquisition. To give precision, with the necessary flexibility, to this principle, 'investments', 'securities' and 'investment business' would be defined in the Act but with power to add or subtract from the definitions, either generally or for particular purposes, by Regulations approved by Parliament. Employees would not need to be individually registered except for those engaged to advise on, or manage the investments of, pension funds or public investment trust companies. The Report also considers the extent to which the same protection should apply to professional as to private investors and recommends that there should be no distinction except for the retention of greater freedom to circulate investment information to 'professionals' defined so as to prevent the abuses to which the present 'professionsals only' has led.

#### LIFE ASSURANCE AND UNIT TRUSTS

The Report discusses problems relating to the two main types of collective investment undertakings - insurance-linked investments and unit trusts or mutual funds. Among the many recommendations are those designed: to control more effectively the activities of unauthorised life offices and of insurance intermediaries; to relax the present tight Departmental control of the authorisation of unit trusts, delegating this to a recognised self-regulatory agency established by the industry; to permit the incorporation in the UK of mutual funds; and to harmonise the types of underlying investment permissible, whether offered through unit trusts, mutual funds or insurancelinking. The Report proposes that insurance intermediaries should be governed by a code of conduct, produced by an industry body, or if not by statute, when marketing life insurance, which would include a rule that clients should have their attention drawn to all 'health warnings' connected with the policy. Other recommendations are: that the Secretary of State should be empowered to promulgate regulations controlling the maximum commissions payable to tied or independent intermediaries and that this power should be exercised so far as possible through self-regulation by the industry; that unsolicited 'cold-calling' for sales of investments should be prohibited by the Act except to the extent allowed by Regulations, which should permit it in respect of authorised life insurance or unit trusts but not otherwise; and that the ten-day 'cooling-off' period should be extended to cover sales of single-premium policies and of trust untis, but that, in their case, the investor should be entitled to the return only the lesser of what he had paid or would have had to pay had he bought on the day of cancellation.

# PUBLIC ISSUES, TAKEOVERS AND INSIDER-DEALING

The Report deals with public issues of securities, takeovers and insider-dealing and recommends that the statutory provisions on these matters should be transferred, in a modernised form, from the Companies Acts to the Investor Protection Act. While no substantial amendments are recommended in respect of insider-dealing, a harmonised system is suggested for regulating invitations to the public whether on an issue or a takeover. The case for pre-vetting of prospectuses and for subsequent surveillance of the companies concerned and of any market-makers in the securities is stressed, particularly in the light of statistics which show that some 30% of filed prospectuses relate to securities which are not to be officially listed or dealt in on the Unlisted Securities Market (USM) a percentage which is likely to increase in the light of the Business Expansion Scheme. A system is recommended whereby supervision would be exercised by the Stock Exchange, in respect of listed or USM securities, and by the CSI and the Takeover Panel in respect of issues undertaken through members of self-regulatory agencies represented on the CSI.

# OFFENCES AND ENFORCEMENT

The Report recognises the problems of bringing about successful prosecutions. There is a recommendation that there should be a review of the method of trial and to the possible substitution of an ordinary jury with lay assessors with relevant experience. It also proposes that the co-ordination between the administrative, investigatory and prosecuting authorities be improved, to ensure that those who ought to be brought to trial have their cases disposed of more quickly.

## The Way Forward

As stated above, the purpose of this debate is to include the House of Commons in the consultation process that is currently being carried out by the Government, before it finally forms its own view. The current intention is that a White Paper should be produced by November 1984.

#### INITIATIVES ON SELF-REGULATION

Initiatives have been taken to establish the appropriate structure and operation of self-regulatory groupings.

The Governor of the Bank of England, in a move designed to help in the management of the change of system, set up a Committee composed of leading City figures on 23rd May 1984 with terms of reference:

'to report within three months on the structure and operation of self-regulatory groupings that would most appropriately cover all types of securities activity (including investment management) together with commodity and financial futures' (Daily Telegraph, 24th May 1984).

The Governor has made it clear that any proposals must attract sufficient support to be capable of early implementation.

In order to keep in step with this initiative, Mr Alex Fletcher has invited the Life Insurance Industry to make proposals for a possible self-regulatory body to cover the selling of life insurance by intermediaries and other sales staff. Their proposals have been requested by the end of August.

#### ENFORCEMENT

The Home Secretary announced on 8th November 1983 that a committee under the chairmanship of Lord Roskill had been established to examine the conduct of serious fraud trials. The committee will look at a number of issues, in particular whether trial by jury is appropriate in these cases, in view of their length and complexity.

Complementing this, the Chancellor of the Exchequer revealed on 3rd July 1984 the Government's intention to change the way in which cases of fraud are dealt with during investigation and pre-trial periods. A new, permanent Fraud Investigation Group will be set up in the Department of Public Prosecutions to deal with serious financial fraud cases. The new Department will come into existence on 1st January 1985.

#### Conclusion

While the Government has come to no firm conclusions as to the final framework for the regulatory system, it is clear that an 'obtrustvely legalistic framework' along the lines of the Securities Exchange Commission has been rejected. Mr Alex Fletcher has outlined one possible way forward. He said:

'the fewer self-regulatory agencies, the less justification for the intermediariy body, therefore the more power can be devolved to the people in the front line, rather than a group of second guessers who aren't practioners ... I just don't want a whole series of little clubs. That is not what the intention is. We are breaking the mould -let's really break it in that respect' (Guardian, 18th May 1984).

The independence of these agencies could be safeguarded by the inclusion on each council of a large proportion of outside members. The agencies' self-regulatory power would be conditional on an adherence to a strict code of conduct. The SRAs could have power to withdraw registration from companies failing to comply with the code. To make this effective Mr Fletcher has suggested that 'they will lay down rules for the members. If there are complaints, they will have power to go in and look at the books' (Financial Weekly, 8th June 1984).

Commenting specifically on the insurance industry, Mr Fletcher has suggested that there is a need for a single Ombudsman to deal with complaints over the whole industry.  $\underline{\text{Mr Tebbit}}$  has summarised the requirements for the self-regulatory system:

'those rules must be robust enough to cope with variations in technique and practice but they must not permit foul play' (London, 26th June 1984).



JF6899
PS / Secretary of State for Trade and Industry

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10 July 1984

# Covering RESTRICTED

David Peretz Esq Private Secretary to the Chancellor of the Exchequer HM Treasury LONDON SW1P 3AG

Dear David,

FINANCIAL SERVICES

My Secretary of State wrote to the Chancellor yesterday about the line he proposes to take in next Monday's debate on the financial services. The other subject to be discussed at the Chancellor's meeting on 11 July with Mr Tebbit and the Governor of the Bank of England is the proposed Stock Exchange reforms. I attach a background paper by officials for this meeting.

My Secretary of State discussed the reforms with Sir Nicholas Goodison last night. He shares the aims set out in paragraph 5 of the paper. Although he sees the Stock Exchange as the market place, he is looking at the future relationship between the Stock Exchange and the over the counter (OTC) market. He is aware of my Secretary of State's concern to encourage competition and the relevance to this of the Stock Exchange's decisions on membership fees and charges. On the need for disclosure there was some difference of view between Sir Nicholas Goodison and my Secretary of State. We accept that there is some trade-off between full disclosure of price and volume of transactions as they are carried out, which Mr Tebbit favours, and the willingness of market-makers to maintain liquidity in the market; it was most important therefore to strike the right practical balance on this question. My Secretary of State noted Sir Nicholas' scepticism about the need for and value of "tiered markets". Finally, there was full agreement on the need for an audit trail.



- 3  $\,$  These points are all covered in the background paper by officials. In particular the conclusions at paragraph 22 could with advantage be confirmed informally to Stock Exchange officials if they are agreed at the meeting on 11 July.
- 4 I am copying this letter and enclosure to Andrew Turnbull and John Redwood at No 10, and to David Bartlett at the Bank of England.

Your eves,

RUTH THOMPSON Private Secretary

Encl



### STOCK EXCHANGE REFORMS

# Background

- A year ago the then Secretary of State reached an agreement with Sir Nicholas Goodison whereby, in return for the Government stopping the proceedings then pending before the Restrictive Trade Practices Court, The Stock Exchange undertook the following:
- (i) action to dismantle by stages minimum scales of stock-broking commissions completing this by 31 December 1986;
- (ii) continuation of rules prescribing the separation of capacity of brokers and jobbers;
- (iii) permission for non Stock Exchange members to become non executive directors of corporate member firms;
- (iv) introduction of lay members to the Council of The Stock Exchange;
- (v) establishment of a new independent membership appeals committee;
- (vi) introduction of lay members onto the disciplinary committee.

Arrangements were made for the Department and for the Bank of England to monitor the implementation of these measures and the evaluation and development of The Stock Exchange as an efficient, competitive and suitably regulated central market which affords proper protection to investors. This we have been doing.

- Towards the end of last year, The Stock Exchange introduced the rule changes implementing (iii) to (vi) above and in March of this year the exemptions legislation we promised was duly enacted. In the following months, the Council of The Stock Exchange (with its 5 new lay members) has been considering points (i) and (ii). In April 1984 it took the first step on (i) by abolition of minimum commissions for overseas securities.
- 3 It also published a Discussion Paper in April, on which there have been over 300 responses, mainly from its own members, and it hopes to reach agreement later this month on a new dealing system, the abolition of commission scales and new membership rules. The outcome will revolutionise the securities industry in Britain.



- 4 This paper outlines the changes proposed. Whilst the Government should not seem to be exerting extra-statutory pressure, Ministers need to be able to satisfy themselves and Parliament that the reforms of The Stock Exchange meet the terms on which legislation was introduced as set out above. Of the many points in the Discussion Paper the following paragraphs comment on the essential ones.
- However, the Discussion Paper omitted one major point, namely The Stock Exchange had no clear marketing objective either nationally in its relationship with the OTC market or internationally in its position vis-a-vis New York, Tokyo and Europe. Following discussions The Stock Exchange are now considering this in detail. Our main policy objectives are a securities market able to provide services to UK industry and commerce, private investors and the Government in the most efficient and cheapest way and which is internationally competitive; and secondly an acceptable system of investor protection.

### City Developments

- Reform was long overdue to strengthen the central market in securities in the British Isles in the face of increasing international competition. Dealing costs (tax and commissions) in the UK are higher than in most major financial centres even after allowance has been made for the cut in Stamp Duty in the Budget. It is now generally recognised that dealers in securities need to be well capitalised in order to take the necessary risks in market making. In the past The Stock Exchange rules on corporate membership have made it more difficult for jobbers and brokers to obtain the necessary capital.
- Response to these competitive pressures was delayed by the RTP case. The agreement last July removed this blockage and by publicly committing The Stock Exchange to reform released and stimulated forces for change. The current regroupings involving jobbers, brokers, banks and other financial institutions are a direct consequence.

# The Reforms Under Discussion

8 Since July 1983 The Stock Exchange programme has changed. The intention had been to dismantle commission scales over a period. The plan now is that a new dealing system will need to be introduced along with freely negotiated commissions in one "Big Bang". A point at issue is the deadline. The Government's deadline is 31 December 1986; Sir Nicholas Goodison has spoken of autumn 1985 or late 1985. There are grounds for us to be concerned about this timetable. The original justification for this of



abolition of commission by stages is no longer relevant. But the big bang cannot take place until the new market making system is agreed and implemented with all the participants trained to use it. This is estimated to take up to 18 months. We will have to accept a move from late 1985 into 1986, but there should be continued pressure on The Stock Exchange to meet the 31 December 1986 deeadline.

- 9 The original agreement specified continuation of single capacity. It is widely accepted that single capacity in its present form cannot survive the advent of negotiated commissions. Thus a different form of investor protection is needed. We will need to be satisfied that this is an integral part of any new dealing system.
- 10 The Stock Exchange has also recognised the need to widen its membership if it is to continue as a competitive market in securities. The Council envisages that the rule limiting to 29.9% outside holdings in a member firm should be removed at the same time as the new dealing system is introduced, or even before if the new dealing and market-making teams are to be fully competent with the new technology on Day One. The main issue on membership for Government is whether the rules that ensure that corporate and individual members of The Stock Exchange are "fit and proper" do not inhibit competition from new entrants. There is a particular point on Japanese firms which is considered in paragraph 15 below.

### Dealing Systems

- 11 Many options have been examined by The Stock Exchange but the current options are:
- (i) a dealing system modelled on the New York Stock Exchange (NYSE), with brokers doing business in front of appointed "specialists" on the floor of the Exchange;
- (ii) a competing market-maker system on the lines of the American over-the-counter market (NASDAQ) using a proven computer information system to publish quotations on a monitor screen (the "Quotation Dissemination System" or QDS) with dealings taking place off-the-floor by telephone. This was the basis of the preferred option 4 system in the Discussion Paper;
- (iii) a totally computer-managed dealing system (called "STARS") into which all brokers would put buy and sell orders, with amounts and price, for the computer program to match.



# (i) The "Specialist" system:

12 Stock-broking firms who have not yet found a source of outside capital and wish to continue their basic brokerage function (eg Cazenove, J Capel, Savory Milln, Phillips & Drew) have supported the NYSE system based on specialists. This has, however, the disadvantage of all floor-based markets that it does not operate round the clock and requires cumbersome regulation to prevent the possibility of manipulation by the specialists. Much business is already done by telephone outside floor hours;

# (ii) The "competing market-maker" system:

This is favoured by the leading jobbers and brokers. particularly those who now have the capability to compete internationally. Competition between risk-taking market makers for business, giving investors the best possible market in which to buy or sell stocks, would be coupled with the reliability and efficiency of a proven computerised information system. It would be a system capable of dealing outside normal trading floor hours. The capital commitment of the market-makers means a more liquid market than other options and investor protection can be assured by electronic price surveillance checking quotations against reported trades. The "audit trail" facility would allow policing of a "best execution" rule and of unusual price movements which might indicate insider trading. The "best execution" rule which requires the business to be done in the most advantageous way for the client meets the requirements of investor protection. This is the option being promoted by Sir Nicholas Goodison.

### (iii) STARS:

STARS ("Stock Trading using Agrregated Resources dealing System") is increasingly favoured by the smaller stock-broking firms. In particular it is suported by the three representatives who recently won places on the Council. The attraction to them is that all firms are treated equally and separation of capacity is built into the system. (Market makers can position themselves on either side of the market but their quotes are only part of the computerised pool.) However it may not prove attractive to the majority - it removes the profit potential from dual capacity and undermines the "relationship" element of the business. A further major snag on timing is that this computer system is still in the development stage and could not simply be achieved by enhancing TALISMAN (the present semi-computerised settlement system): like Star Wars, STARS is for the future and could not be a reality by December 1986. It may be that such a system could provide a basis



for trading in smaller stocks and development may be continued with that in mind.

- None of these dealing systems have obtained unanimous approval so compromises have been suggested. "tiered-market" is one such compromise. The difficulty is that tiering means different things to different people. Some proposals would cause us considerable concern; others less so. In the first category would be a system whereby internationally traded securities would be shown on the computer-based QDS and the less frequently traded securities would continue to be traded by jobbers and brokers on the old Stock Exchange floor. The dangers are that this would set up an arbitrary distinction between quoted companies to the detriment of smaller growing companies. Technologically it would need two market support systems with all the added costs, complications and potential delay. The jobbers and brokers dealing on the bottom tier would be left with the least profitable business (following the advent of negotiated commissions) and there could be pressure for retention of restrictions eq the retention of stamp duty for the jobbers.
- 16 A method of "tiering" the market which might avoid the worst pit-falls would be to let orders for less-frequently traded stock be matched on the floor of the Exchange by single-capacity firms whilst the bulk of trading took place off the floor on the telephone. This recognises the difficulty in forcing market-makers to provide a fully liquid market at all times in all securities. Nonetheless, The Stock Exchange's ability to handle transactions of widely different shapes and sizes within the same system is one of its main strengths. It is something which is worth retaining if at all possible. Any compromise on "tiering" will need to be strongly justified.
- 17 The advent of dual capacity for the market-makers and broker-dealers who replace the single-capacity jobbers and brokers needs to be coupled with the introduction of effective means of investor protection. Immediate publication of all prices and quantities traded has been shown in the USA to provide this. Moreover American experience shows narrower dealer spreads, increased volume of trading and improved members' margins. The Stock Exchange members may decide to adopt a "last trade" tape themselves. If not, this issue (unlike other more technical aspects of the debate) does require Government to make it known that such a tape is necessary.

### Membership

18 It is the prospect of the end of single capacity which has been the main stimulus to regroupings between firms. A



revision of Stock Exchange membership rules to allow 100% outside ownership is to be welcomed for the additional capital it will bring to the UK securities market.

- 19 The proposal in the Discussion Paper for limiting the number of Stock Exchange members and creating "seats" is however of concern because of its potential to restrict membership.
- The Stock Exchange is considering including an element of international reciprocity in the vetting of foreign applications for membership. This would apply particularly to Japanese securities firms given the difficulty for British firms in establishing in Japan branch offices dealing in securities and obtaining membership of the Tokyo Stock Exchange.

### The Gilt Market

21 This is primarily a matter for the Bank of England and the Treasury. But private investors are involved. Their needs for information and investor protection should be recognised in a way consistent with that developed for the equity market.

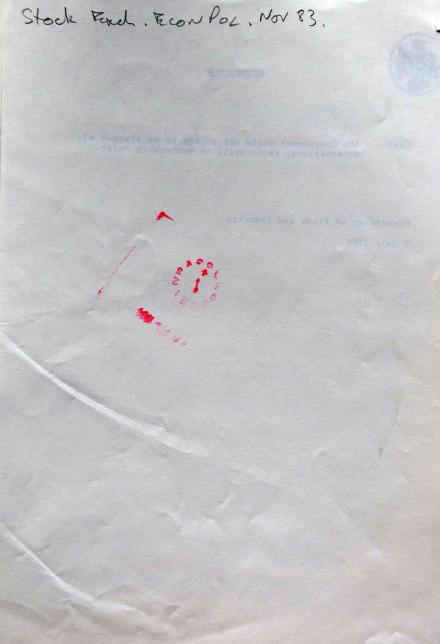
# Conclusion

- 22 A number of important issues will be settled during this month. Of those of interest to Ministers it is recommended that officials should make known to the The Stock Exchange in the informal context of The Stock Exchange Monitoring Group the following points:
- investor protection would be best met by disclosure. There are however degrees of disclosure and we would support:
  - (a) a best-execution rule;
  - (b) the existence of an "audit trail";
  - (c) immediate publication (either on screen or tape) of the price and volume of transactions as they are carried out;
- (ii) a tiered market could create more problems than it solves; we would regard it as acceptable only if it is totally unavoidable;
- (iii) fees and charges for membership are acceptable only if they do not constitute a barrier to new entrants;



(iv) the Government would not object to an element of international reciprocity in membership rules.

Department of Trade and Industry
9 July 1984



NAPM

DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET LONDON SWIH OET

Telephone (Direct dialling) 01-215)

GTN 215) " (Switchboard) 215 7877

Secretary of State for Trade and Industry

London SW1

The Rt Hon Nigel Lawson MP Chancellor of the Exchequer HM Treasury Parliament Street

3 July 1984

Dear Chanallor

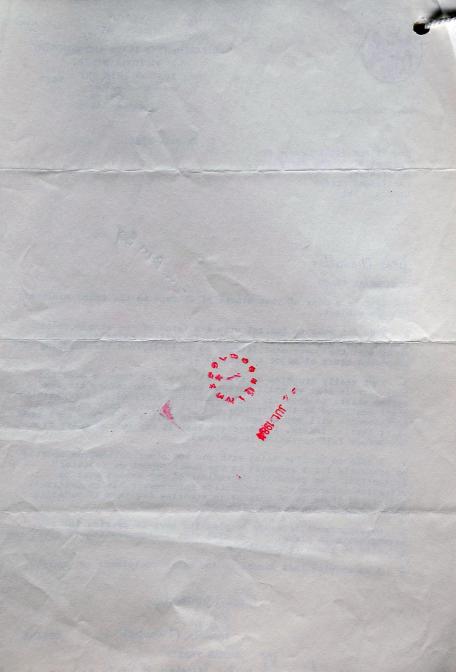
COMMERCIAL FRAUD

You sent me a copy of your minute of 29 June to the Prime Minister on this subject.

- I do not want to quarrel with the terms of the announcement. Indeed, I am pleased that something is at last being announced about what the Government intends to do to improve the handling of suspected cases of major commercial fraud.
- What really troubles me after all that has gone on over the past year is that we still have to wait so long before the new system starts to operate. Moreover, the difficulty in recruiting staff mentioned by the Attorney General suggests that the new arrangements will not be operating with full effect from some time after that. Indeed, I understand that it may be two years from now before full operation is achieved.
- 4 I hope to be discussing with you and other colleagues shortly my proposals for a response to the Gower Report on Investor Protection. An essential ingredient of any system must be effective enforcement. Ineffective enforcement has no deterrent effect and there is no purpose in creating new laws if existing ones cannot be vigorously enforced.
- My Department is ready to play its part in getting the new arrangements in place. I do urge that implementation is given top priority by those responsible.
- I am copying this minute to the other recipients of yours.

Your sincerely, Porth Monpor

( arrowers by the Secretary of State and signed this







# 10 DOWNING STREET

From the Private Secretary

2 July, 1984

# COMMERCIAL FRAUD

The Prime Minister has seen the Chancellor's minute of 29 June. She is content with the proposal to establish a permanent and strengthened Fraud Investigation Group to replace the existing ad hoc arrangements. She is also content with the terms of the draft Answer. Please could you send across a copy of the Chancellor's speech.

I am sending a copy of this letter to Richard Stoate (Lord Chancellor's Office), Hugh Taylor (Home Office), Callum McCarthy (Department of Trade and Industry), Henry Steel (Attorney General's Office) and to Richard Hatfield (Cabinet Office).

(A. Turnbull)

D. Peretz, Esq., HM Treasury.

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# 10 DOWNING STREET

# Prime Minuster

Financial Months and Building Societies Policy Unit has drawn together notes on various developments in knowned markets. Sperific responses are songht from you on

- Building societies

- Investigatia of traud

The rotes an

- Fraud and muestar protection

- Stock Exchange

precede submissions from DTI

A number of best questions could be varied at the lunch with Barings.

AT 29/6

## PRIME MINISTER

# THE CITY

Several City matters will be coming up in the next few weeks:

(hancellow has minuted on this,

- The Chancellor's proposals for more effective investigation of fraud.
- A decision on what steps should be taken to reform the law on investor protection following the Gower Report.

Endosed

- The publication of a Green Paper on the future of building societies.
- The Stock Exchange council should set out its views on the future structure of the Exchange following its April Consultative Document.

Mr Tebbit wants a major debate in the House of Commons before the summer recess, when the Government will need to set out its thinking on all three issues.

These topics are part of much wider changes in the world of finance. It is not up to the Government to formulate some blueprint of what should happen in fast-changing markets. But the trend towards financial conglomerates, as in the

USA, is unmistakeable. This means big organisations with large capital resources and good contacts with the major institutions. They might act as financial advisers to a company, raise money for the company, and then make a market in its shares and other financial instruments. At the retail level, financial "supermarkets" should make "one stop" financial shopping possible. The local branch of a bank or building society could handle banking requirements, advise on how best to invest savings, help insure a house, and carry out Stock Exchange transactions. The attached note shows what a conglomerate might do.

The sceptics argue that the conflicts of interest in financial conglomerates are so acute that they will not prove workable. But American experience doesn't bear this out. Any firm involved in shady dealing or selling pups to an investor would rapidly lose business. Conflicts of interest exist already within many merchant banks; they would be more difficult to exploit if vigorous disclosure is required. If a merchant bank places shares to raise money for a corporate client by selling them to its investor client, we need clear disclosure of its interests and of the price and timing of the deal.

There should be <u>four main themes</u> to the Government's approach to financial institutions. They provide the criteria against which the particular proposals put to you could be judged.

Pirst, the Government should do nothing to obstruct the free operation of commercial forces. The financial sector accounts for about 13 per cent of GDP and contributes £1.5 billion to the balance of payments. It is a successful, profitable area of the economy which should not be stifled by over-regulation. It is rivalled only by micro-electronics and information technology as a booming area of the British economy. The Government should reap political benefits from associating itself with this success story.

Secondly, financial services should be in the forefront of competition policy. The City has a dangerous tendency to favour the cosy, clubby cartel. The Stock Exchange has been outpaced by New York over the past 10 years because of this. The sudden release of energies in the Stock Exchange following Cecil Parkinson's pressure on them is a good example of what can be achieved - dealing fees will come down, and the range of services expand. The forthcoming legislation on building societies is another opportunity - they strengthen their role as providers of housing finance and are free to compete with local solicitors, estate agents and, in some areas, banks.

Thirdly, individual share-ownership is a major Government policy. Many factors will help push it forward, ranging from second-generation home-ownership (with the prospect of

inheriting capital that can be invested in shares) to low inflation, improved industrial performance, and a growing aspiration to have a say in the business.

But changes in the financial sector should also help. There is a large potential retail market which conservative British firms have been reluctant to exploit. Banks and building societies have extensive retail networks, with under-employed and unionised staff. They will either have to cut them back or use them more intensively to market a wider range of financial services. If they don't, the Mark Weinbergs of this world will outwit them by using outlets like stores to provide these services.

Maximum disclosure of information. City operators like operating behind closed doors and giving their trade an unnecessary mystique. This increases the risk of malpractice or of overcharging, and puts Mr Everyman off. Wherever possible we should press for the maximum possible information in the most digestible form.

The most ruthless guardians of the customer's interest are competition and disclosure. The attached notes apply these principles to the Gower Report on Investor Protection, Building Societies, and the Stock Exchange.

David Willetts

JOHN REDWOOD/DAVID WILLETTS

# WHAT A CONGLOMERATE COULD DO

The Activity

Existing Institutions

Banking

Money transmissions and

current accounts

Deposit accounts

Clearing Banks Merchant Banks

Overdrafts

Investment

Advice on a transaction in stocks and shares

Investment vehicles (unit trusts, etc)

Merchant Banks

Stockbrokers & Jobbers
Investment Houses, Banks

and Brokers

Property

Surveying and estate

Property development

agency

Conveyancing

Building Societies Estate Agents

Lawyers
Surveyors
Investment Managers

Insurance and Saving

Life

Pensions

General

Composite Insurance

Companies Lloyds

Life Companies

# FRAUD AND INVESTOR PROTECTION

Mr Tebbit will be putting forward to you next week his views on how to sort out the existing messy law on investor protection. The Chancellor should be putting forward to you today practical proposals for improved investigation and prosecution of fraud.

There are three different approaches which Mr Tebbit will set out:

- i. Direct regulation by DTI.
- ii. A set of self-regulatory agencies covering various financial functions. They would in turn be supervised by the DTI itself, or possibly some intermediary body along the lines of the Council for the Securities Industry.
- iii. The minimalist approach which says the consumer is best protected by information, competition, and basic legal requirements rather than a panoply of regulations, whether proposed by government or the City itself.

Mr Tebbit is likely to press for self-regulation. We still believe in the power of competition and disclosure.

Setting aside our fundamental worries about the SRA option, there are also severe doubts about its practicality. It isn't clear that the City will be able easily to organise itself into a small number of SRAs, or that they would be able to get to grips with the complexities without a strong emphasis on disclosure, competition and a law on fraud. This is the question which the Governor's informal group of experts is looking at, and which may come up at lunch at Barings on Monday.

We broadly welcome the Chancellor's practical proposals for strengthening the investigation and prosecution of financial fraud. They are the most effective way of protecting investors.

## THE BUILDING SOCIETIES GREEN PAPER

We welcome the Chancellor's approach.

There are four main themes to the Green Paper:

- i. Building societies must remain a safe, reliable place for the small investor to put his savings. They don't have the management resources or skills to engage in fancy financial and lending operations risking significant amounts of their assets. The last thing we want is a building society crisis in a few years' time like the secondary banking crisis of the 1970s.
- ii. The building societies have done a lot to spread homeownership and their activities should continue to be
  focussed on this key objective. The Green Paper
  suggests a rule that 90 per cent of building
  societies' assets must be mortgages on residential
  property. We are happy with that.
- iii. But there is scope for building societies to provide a rather wider range of services, particularly related to housing and land. So they could use up to 10 per cent of their assets for, for example, buying land and housing directly. They should also be free to engage in conveyancing and property surveying. And finally,

their retail network is well-suited to a variety of financial services like carrying out share transactions for clients, or paying people's bills by transfers. If they wanted to move into these areas, there would be more healthy competition in the high street.

iv. The Green Paper is a prelude to new building society legislation in the 1985-86 Session, as the 1962 Building Societies Act is now very much out of date. As the financial scene is changing so fast, the new legislation must be more flexible than the old legislation was so that, where possible, regulations can be changed by Statutory Instruments rather than new primary legislation.

All these good strong themes are in the Green Paper. But we have three suggestions for livening it up.

First, it would benefit from a short, punchy Ministerial foreword highlighting the themes set out above. A lot of people won't have the time or energy to wade through the 35-page document and discover the hidden nuggets.

Secondly, the discussion of building societies' activities in Europe in Chapter 3 could be more positive. The Government is keen to argue for free trade in financial

3.25 -

services throughout the community, and there is no harm in bringing out the point here.

Thirdly, the discussion of possible extensions of building society services in Chapter 4 is cautious. Instead of saying that the Government waits to hear from the societies, it should say that the Government in principle favours this subject to the views of the societies.

### THE STOCK EXCHANGE

If I wish to buy a share at the moment, I have to do so through a stockbroker who is a member of the Stock Exchange.

The broker acts as my agent: he seeks prices from the jobber members, and buys from the cheapest.

Throughout the transaction, the stockbroker never owns the stock. He has to ensure the best price for his client at the time, and smooth settlement of the transaction.

The jobber - or market-maker - stands ready to buy or sell shares from all comers at a price of his choosing. He is the Stock Exchange bookie. He is protected from quoting a price that is way out of line with that of the other jobbers; he is always bound by the rules of the Exchange. In return, he enjoys several privileges. He gets favourable treatment over the payment of dividends on stock he owns; he effectively escapes the payment of all Stamp Duty on his holdings; and, most important of all, the jobber is told about any broker-to-broker deal (order exposure) and can insist on buying or selling stock with one of the dealing brokers at their chosen price.

For the individual client, this system has some disadvantages:

### THE STOCK EXCHANGE

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For the individual client, this system has some disadvantages:

- he cannot negotiate direct with the jobber from whom
   he is buying his share
- he is paying commission to the stockbroker and the jobber's "turn" (the gap between the price at which he bids for stock and the price he offers back)
- the stock-jobbers do not have enormous capital resources to back them up, so it may be difficult to deal in large size in many company securities.

# Forthcoming changes in the system

The system is now being torn apart as a result of the OFT case. The separate functions of jobbers and brokers will go. Many small stockbrokers are worried that they will lose out, as they twin with banks and/or jobbers to make markets in a whole range of securities. Small broker backwoodsmen are now well represented on the Stock Exchange Council. They will be advocating a traditional role.

Some fear the Market's liquidity will dry up under this new system. There is, so the argument runs, a range of second-line stocks dominant in number but not in turnover, where the new market-makers would not be interested in always being ready to buy or sell. But the present system is hardly ideal. You can only deal in very limited size in most small company stocks. And if anything, the overall

effect of the new system will be to increase market liquidity because (a) costs of dealing will fall, encouraging more turnover; and (b) there will be more risk-takers running a barrow in the market.

The backwoodsmen want a compromise; of a two-tier market with an upper tier of highly-traded stocks being traded by combined broker-jobbers; and in the first instance, a second tier of stocks handled through a system reminiscent of the current one. We should be extremely wary of it. It would only be a compromise related to the faction squabbles of the Stock Exchange: it would have little basis in logic.

Second-line stocks would soon be traded like first-line stocks.

### What should the Government's role in all this be?

The Government should protect the customer by insisting that dealers reveal all, and seeing sufficient competition in the system, so that commissions and prices can be brought down. It should not plunge into the faction squabbles of the Stock Exchange and come up with a view of how the system is to operate. It should, however, be quite firm that it requires a central electronic marketplace with continuous recording of prices, volumes traded and last-trade price. It should make clear that in the revised settlement system now being put into the Stock Exchange, an individual should expect to see on his contract note the time of dealing as well as the

day, the then market price, and the price commission charged by the broker-dealer or whoever. This is the <u>only</u> way to protect the customer and is an <u>improvement</u> on the present system.

The Stock Exchange will fight to preserve the membership of the club as the regulatory body for dealing activities. The Government should not necessarily object to this, but its competition policy arm should make sure that entry to the club can be achieved on reasonable terms, and the club does not convert itself back into a price-fixing cartel.

The Stock Exchange needs to come up with working proposals for a dealing system soon. If it does not, there is a risk that the necessary computer technology for an electronic marketplace will not be in place in time for the new system to be operating by 1986.

<u>We recommend</u> the Government's immediate aim should be to encourage an early solution.

CONFIDENTIAL



Prime Minusion

To note (Live get a copy of the speed referred to)

Treasury Chambers, Parliament Street, SWIP 3AG OI-233 3000

PRIME MINISTER

### COMMERCIAL FRAUD

We have for some time been examining ways of making more effective the handling of suspected cases of major commercial fraud. Setting up the Roskill Committee was one strand of this initiative. After extensive discussions with the colleagues and Departments concerned, arrangements are now in place for establishing a permanent and strengthened Fraud Investigation Group (FIG), to replace the existing ad hoc arrangements to deal with individual cases. The initiative is also a modest but useful prelude to our response to the Gower Report on Investor Protection.

- 2. The Group will be set up in the Department of the Director of Public Prosecutions. It will be headed by a Controller, who will report to the DPP, and through him to the Attorney General.
- 3. New resources are being made available to the DPP, during the current financial year, in order to set up the new group, though Michael Havers tells me that, because of difficulty in recruiting suitable staff, it will not be possible to meet our original target commencement date of 1 January 1985.
- 4. The Group will be staffed by prosecuting lawyers, specialist accountants, and the necessary supporting staff. The ground rules have been agreed in principle by all Departments concerned. Further details are now being discussed by officials, but there is no need to hold up an announcement on this account.



- 5. Subject to your views, I intend to announce these new arrangements on Tuesday 3 July. I enclose a draft written Parliamentary Question and Answer. I also propose to include a passage on these new arrangements in a speech on the same day about changing financial markets.
- 6. Michael Havers thinks, and I very much agree, that it would be a courtesy to give Lord Roskill advance warning of this announcement. I hope that the Lord Chancellor, to whom I am copying this letter, would be prepared to take this on.
- 7. I am copying this letter to the Lord Chancellor, the Home Secretary, the Secretary of State for Trade and Industry, to the Attorney General and to Sir Robert Armstrong.

N.L. 29 June 1984



### DRAFT OUESTION

To ask Mr Chancellor of the Exchequer, if he will make a statement about the arrangements by which cases of serious commercial fraud are investigated.

### DRAFT ANSWER

The Government has reviewed the arrangements for investigation and prosecution of fraud cases. This work has been complementary to that of the Committee under the chairmanship of Lord Roskill, announced by my RHF the Home Secretary /Hansard reference/, which is considering the conduct of criminal proceedings in England and Wales arising from fraud.

The Government has concluded that the present arrangements by which fraud investigation groups comprising representatives of the police, the DTI and the Director of Public Prosecutions are constituted on an ad hoc basis for particular cases, should be put on a permanent basis. This new Fraud Investigation Group will be set up in the Department of the Director of Public Prosecutions. It will be headed by a Controller, who will report to the Director and, through him, to my RH and Learned Friend the Attorney General. The group will be staffed by prosecuting lawyers, specialist accountants and the necessary support staff. Some of the new staff will be seconded from the DTI. The Group will be able to request the DTI to carry out investigations under the Companies Act, although final decisions on such investigations would still be for the Secretary of State. The Group will also work in close cooperation with the police.

The new arrangements will take effect as soon as possible in the New Year. Detailed ground rules for the referral of cases to the new Group are under discussion. A further announcement will be made in due course about the implications for the Department's expenditure provisions.

# DINNER WITH CHAIRMAN OF STOCK EXCHANGE AND COUNCIL MEMBERS TUESDAY, 12 JUNE 1984

The Stock Exchange is still somewhat divided about its future.

There is growing agreement about the need for:

- a. time-stamping or contract notes to enable checking of prices against market prices;
- b. wider disclosure generally;
- a faster electronic settlement system;
- d. an electronic marketplace superimposed on the traditional marketplace based on the trading floor;
- e. the Government Broker/Bank of England suggested arrangements for the gilts market.

There is more uncertainty about the likely form of trading in the equity market. Whilst many are running the compromise of retaining a separate jobbing and broking system for the smaller stocks - whilst allowing the larger stocks to be traded freely by single-capacity specialists - there are many others who are sceptical about whether such a compromise would stick. The overall impression was of continuing drift towards greater radicalism, which will only be arrested as and when the Stock Exchange Chairman gets together firm proposals and tests them in a vote of the Members.

There was also a growing wish to see the Government relax on the timescale laid down for the changes. There seems no reason to do this, as the time pressure is the one thing that might force the Stock Exchange into making a decision sooner rather than later, which would help the membership as well as the customers, as it would then end the long period of, uncertainty.



JF6654 Secretary of State for Trade and Industry

> Whitehall LONDON SW1A 2AT

The Rt Hon W John Biffen MP Lord Privy Seal and

Privy Council Office

Leader of the House of Commons

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET

LONDON SWIH OET

Telephone (Direct dialling) 01-215) 5422

GTN 215) (Switchboard) 215 7877

// June 1984

Mr Tushul h see

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D. John,

REVIEW OF THE FINANCIAL SERVICES SECTOR

I am writing to hoist a flag - tentatively and provisionally at this stage - about the possibility of finding Government time during July for a debate on financial services.

- By the latter part of July six months will have elapsed since Professor Gower's report on investor protection was published, and some two and a half since the end of the period offered for comments. I think it is both necessary and advantageous to give the House a broad indication of Government thinking on this important and complex subject before the Recess. Although the subject matter may be somewhat specialised, the Government's response to developments in the City, the Stock Exchange and to the Gower Report itself is awaited with much interest in Parliament.
- 3 I am planning to put my thoughts on the substance to colleagues later this month. While much will depend on their views, I see advantage in providing Government time for a debate rather than conceding one, in taking the Parliamentary temperature rather more fully than a statement would allow, and in doing so before we issue a White Paper in November, and before preparation of Instructions to Parliamentary Counsel has got to the point where only detailed changes can be considered.



 $4\,$   $\,$  I am sending a copy of this letter to the Prime Minister and the Chancellor of the Exchequer.

NORMAN TEBBIT



# 10 DOWNING STREET

CL HITT David Willetts (FO)

THE PRIME MINISTER

18 May 1984

llean Pohi.

Thank you for your letter of 10 May on regulation of securities markets. You will also have seen Norman Tebbit's minute to me of 11 May.

I understand that you had a meeting with Nigel Lawson and Alex Fletcher on Wednesday, when it was agreed that it would be right for you to proceed with setting up the advisory group you propose so long as it was clear that the group is being set up to give you advice, so that its recommendations would in no way restrict the Government's options in looking at a wider range of possible regulatory arrangements. It would also be made clear that its remit will be confined, as you suggest, to looking at whether a self-regulatory system could be made to work, and if so how.

I also understand that you are now hoping that the group would be able to give interim advice by mid-July.

Like Nigel and Norman, I am content for you to ahead on this basis, and to announce the initiative on 23 May, as you suggest.

Copies of this letter go to recipients of yours.

R. Leigh-Pemberton, Esq.

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Your ton

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#### Treasury Chambers, Parliament Street, SWIP 3AG OI-233 3000

17 May 1984

Andrew Turnbull Esq 10 Downing Street LONDON SW1

PERSONAL

Dear Andrew

SECURITIES REGULATION DATED 17 MAY

As we agreed last night, I am attaching a draft of a reply the Prime Minister might send to the Governor's letter of 10 May. The Chancellor has seen this and is content.

Your ever, David

D L C PERETZ Principal Private Secretary

DRAFT LETTER FROM THE PRIME MINISTER
TO: THE GOVERNOR
BANK OF ENGLAND

#### SECURITIES REGULATION

Thank you for your letter of 10 May. You will also have seen Norman Tebbit's minute to me of 11 May.

I understand that you had a meeting with the Chancellor and Alex Fletcher Yesterday, and that Nigel too agrees that it would be right for you to proceed with setting up the advisory group you propose, so long as it is clear that:

the group is being set up to give you advice, so that its recommendations would in no way restrict the Government's options in looking at a wider range of possible regulatory arrangements. and

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Like Nigel and Norman, I am content for you to go ahead on this basis, and to announce the initiative on 23 May, as you suggest.

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PRIME MINISTER

#### Securities Regulation

I detect some ill feeling in the Treasury about this letter. They feel that there has been a deal between the Bank and DTI without bringing them in. The Chancellor will be looking at the papers over the weekend and will respond next week. You may want to discuss this at the bilateral on Wednesday. As the Policy Unit point out, the Governor's proposal could further delay the Government's response to the Gower report. I also find unappealing a group of City Chairmen grappling with the problems of regulation when new market structures are developing. Of its nature, a group of this kind will exclude the most innovative spirits. I suspect the purpose is that the Bank will provide the secretariat, enabling them to write the script.

Agree no response until you have had a chance to confer with the Chancellor?

Mustonle bottrik Chardler and SVJS.

BIF in Chardens shate of folders

11 May 1984

#### PRIME MINISTER

The Governor's letter is to be welcomed in so far as it shows that the debate in the City is now opening up concerning the future of the securities industry and how to regulate it.

My discussions with the Bank of England, the Chairman of the Stock Exchange, senior partners in stockbroking organisations, and directors of investment businesses indicate that there is still great uncertainty about the future course of Stock Exchange trading, and even more disagreement about an appropriate way of regulating it. Rushing into Gower is now, therefore, rightly thought to be dangerous.

If the Governor wishes to form a senior group to help him think through appropriate proposals, that is fine. It is not, however, a good idea to associate the Government with this process. It immediately raises the question whether this group is short-circuiting all the other groups and organisations like the Stock Exchange Council who have a legitimate interest in the formulation of proposals. There could be rows over who is and who is not consulted, and we cannot guarantee that the result of their deliberations will be a better sytem than anything so far on offer.

The Governor's letter also conceals a danger in his statement that the logic of events "might push us towards some kind of statute-based Securities Commission" like the SEC. One of the reasons why London is picking up some American business is because the SEC tends to over-regulate. Alan Walters' thoughts on the SEC are unprintable. Whilst the development of the markets makes regulation difficult to formulate, the need for a clear law to protect investors and for information about dealing will not be changed by events, and is the proper task for Government. The Governor's proposals would slow it all down and prevent Norman Tebbit sticking to his timetable on these crucial subjects.

I think the Government should stick to its line that it is sifting all the evidence on Gower from the recognised institutions who are submitting their comments; and will formulate its own proposals on an appropriate investment law. The results of the Governor's deliberations would be of interest, but would not be endorsed in any way by the Government. The Chancellor and Norman Tebbit should be consulted before responding to the Governor. Then you could respond.

JOHN REDWOOD

LASAAT





PRIME MINISTER

#### REGULATION OF SECURITIES INDUSTRY

The Governor of the Bank of England has told me that in the next day or two he will be writing to tell you of a personal initiative which he proposes to take to invite a small group of top City people to advise him quickly on whether and how feasible arrangements for self- regulation in the securities industry can be developed. This is the Governor's response to pressure from the City for constructive action now to develop self-regulation as the City's response to the Gower Report.

The Governor is keen to make an early announcement. Since I shall be away in the United States next week, I send you this minute now to let you know that he has discussed the idea with me. I believe that it will be a useful step to see what the City believes it can actually deliver by way of self-regulation: I propose to welcome it on these terms publicly.



- 3 The Governor's personal initiative does not close off any of the policy options open to the Government. It would show what may be feasible in the development of self-regulation in the securities industry while allowing the Government itself to stand back a little. At this stage it would be action by the City itself to see what they can do to take forward the self-regulation advocated by the majority of comments received on the Gower Report.
- 4 Meanwhile work will go forward in my Department, in consultation with the Bank of England, on the Gower recommendations and the representations received. The closing date for these was 30 April. 85 representations were received during the last few days. They include support for all three main options, of a minimalist approach, of a full-scale securities commission, and for self-regulation within a statutory framework.
- 5 I want to take this work further before reaching any conclusions. The line of argument which was put in your Private Secretary's letter of 10 April, has since been developed into a useful paper by your Policy Unit. I want to review all the options fully before coming to a view.



The proposed initiative by the Governor does not close off any of these options.

- 6 I am considering with the Governor whether the Department should have a senior official as an observer on the proposed group, but I think it is better to keep at arm's length at this stage. We can keep in touch with the group and the way its thinking is developing through the Bank.
- 7 I am sending copies of this minute to the Chancellor of the Exchequer and the Governor of the Bank of England.

NT

// May 1984

USR

BANK OF ENGLAND

R11/5

The Rt Hon Margaret Thatcher MP 10 Downing Street London SW1 10 May 1984

LONDON EC2R 8AH

Dear Prime Prince

#### SECURITIES REGULATION

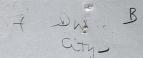
- l My purpose in writing to you is to describe briefly an initiative that I have in mind in the area of securities regulation. I have discussed it in some detail with the Secretary of State for Trade and Industry and he has indicated to me that he would welcome it. I believe that it is consistent with your own concerns about any immediate government involvement as described in Andrew Turnbull's letter of 10 April. Subject to your views and those of the Chancellor of the Exchequer, I would like to be able to launch it shortly.
- Developments in the securities area since last July seem to me to have vindicated the government's decision to take the Stock Exchange case out of the restrictive practices process. New trading structures more compatible with the fast-growing world market are being formed. In particular, there are already some prospectively very strong British groupings that will enable us to look to compete internationally on equal terms. An inevitable consequence of these developments however is that activities and functions that have hitherto been separated institutionally will now take place within a single organisation. As a result the scope for conflict of interest is being significantly widened. Although there is a minority which sees no need for any regulatory adaptation to match this market development, I am sure that the majority view in the City is that existing arrangements do not suffice.
- 3 It is, however, difficult to judge at this stage what type of overall regulatory structure is likely to be appropriate in the longer term. At one extreme, we cannot altogether exclude that, at the end of the day, the logic of events might push us towards some form of statute-based securities commission such as exists in the

United States, but I hope we can avoid this. The potential conflicts of interest within an institution will raise questions more serious and complex than malpractice or overpricing. They will take us well beyond the reach even of an improved Prevention of Fraud Act, into areas where "caveat emptor" is no longer a sufficient guiding principle. The City still has a strong commitment to compliance with the spirit of high standards and good practice. We should not lightly displace this by any system which shifts the emphasis away from dependence on the inherent integrity of the majority of practitioners to one in which anything goes which can be done within the letter of detailed rules. Thus, I think it important to give the proponents of non-statutory regulation an opportunity to show how and how far the approach that they favour is capable of being strengthened from within, to cope with the changing market environment.

- 4 As I see it, this would put self-regulation on its mettle while enabling us to keep options open for a little longer on the shape of legislative change or other action that Government may decide to take at a later stage, partly in the light of the progress made on a non-statutory basis in the meantime. What I have in mind is to invite, on my own initiative and without committing Government, a small number of senior City practitioners, at chairman level, to form an advisory group to make proposals to me, within the next 2-3 months, for a structure for non-statutory or self-regulation that would be capable of swift implementation if we thought it desirable.
- Norman Tebbit has kindly indicated that he would be ready to welcome publicly an initiative on these lines and, subject to your views, I would like to be able to launch it in a speech that I will be giving on 23 May, which provides a convenient opportunity and forum.
- 6 I am copying this letter to the Secretary of State and to the Chancellor and if you or they felt that it would be useful to have any discussion about all this, I should of course be very pleased to do so.

lours eve,

Andrew Turnbull





## 10 DOWNING STREET

4 May 1984

Alex Fletcher Esq MP PUSS Department of Trade and Industry 1 Victoria Street LONDON SW1

I have pleasure in enclosing a note concerning some of the issues that arise from the Gower Report.

This is a statement of the case that we put to you the other day as a contribution to your debate.

Yours sincerely

JOHN REDWOOD

4 May 1984

#### INVESTOR PROTECTION

#### The Need for Action

1. We accept that the current position is unsustainable. The existing legislation for protecting investors is incomplete and out- of-date. Some operations such as unit trusts - are at present directly regulated by the DTI, whereas others - such as commodity investment - operate outside any real legal framework. In addition, the emergence of financial conglomerates and the ending of single-capacity on the Stock Exchange create greater potential conflicts of interest. The impetus behind these changes must obviously come from the private sector, but the Government can contribute by establishing a clear legal framework for investor protection.

#### Objections to Gower

- 2. We believe there are three key flaws in the Gower approach.  $% \begin{center} \end{center} \begin{center} \end{center}$
- 3. First, it conflicts with one of the fundamental tenets of this Government that Government should not appear to take on responsibility for matters which are not actually under its control. Under Professor Gower's proposals, the DTI registers, directly or through SRA members, all those permitted to carry out investment business. This must inevitably become a seal of approval and paradoxically, this problem will be more acute the greater is the success of Professor Gower's proposals in ensuring the probity of investment businesses. If and when a registered investment business is found to have been engaging in criminal malpractices, it will be claimed that the DTI and the Ministers responsible have not been doing their job properly. Yet no amount of regulation will stop occasional criminal activities.
- 4. Secondly, self-regulatory bodies intended to keep out the wide boys can easily become <u>cartels</u> keeping out the new boys. Self- regulation tries to apply the ethics of the club to business life. Whilst it may be effective with socially homogeneous groups operating in a relatively stable environment, it is much less likely to be appropriate to a period of rapid financial change when new firms and new types of transaction may displace traditional ways of doing things. There is a clear risk that self-regulatory agencies will act as a brake on change. Professor Gower's response to this is to propose the regulation of the SRAs by the CSI and/or the DTI. But close and effective supervision would remove the substance of self-regulation, and involve the Authorities too closely.

- 2 -

5. Thirdly, Gower identifies, but does not satisfactorily resolve, the problem of the coverage of the different SRAs. The option of making them simply functional is attractive, but it is not clear whether a conglomerate would then fall to be regulated under several different SRAs, or would become the prime responsibility of one specific SRA.

### The Alternative Minimalist Approach

- 6. We start from the view that the best protection for the investor comes from <u>information</u> and <u>competition</u>. The terms on which investment funds are solicited or deals are done should be published or broadcast. And if individuals get a bad deal, they can take their business elsewhere.
- 7. But this "caveat emptor" approach needs to be supported by much tougher legal requirements and enforcement powers than at present. The law covering investment business should be modernised, clarified, and extended. It would set out legal obligations, such as separation of client monies, the breach of which would constitute a criminal offence.
- 8. The law would have to be made effective by much better enforcement arrangements. There is a strong case for replacing the fraud squad and the DTI with a new investigation and prosecution agency which would have the power to go into firms and inspect their books on suspicion that a crime had been committed. It could then bring prosecutions for breaches of criminal law it would be for individuals to pursue common law cases such as breach of contract.
- 9. This approach goes with the grain of the Government's philosophy. There is no register of invesment businesses, and hence no suggestion of Government endorsement. The client's main protection comes from maximum possible information and the normal forces of competition. It has other advantages as well:
- The prospect of criminal penalties if caught is much more severe than disciplinary action by an SRA. So the deterrent is greater.
- ii. It is a much more flexible system which can continue to operate as market structures change, and is not subject to the practical difficulties of overlapping SRAs.
- 10. We accept that the minimalist approach could mean that the public authorities were more closely engaged in the

- 3 -

investigation and prosecution of financial institutions than under the Gower proposals. This is simply a consequence of relying on the criminal law rather than self-policing. We do not see it as a drawback. Moreover, most incidents of wrong-doing would be cleared up by the normal forces of competition or individual common law cases.

- ll. We also accept that this approach might not be compatible with the continuing existence of SRAs. If financial institutions carrying out certain functions gather together in professional associations, there is no reason for the Government to obstruct this. But in order to be effective as an SRA, it would need powers to call for information and to punish members. It is not clear that these would be consistent with existing restrictive trade practice legislation of self-regulation and the objectives of competition policy may conflict here. We would not favour any exemptions from existing competition legislation.
- 12. It is important that the Authorities obtain sufficient information to discover wrong-doing and to prosecute successfully. Under a system of self-regulation, the SRAs in effect operate as voluntary collectors of information on which either they act themselves or which can be passed on to the prosecuting authorities. If there were no SRAs, or at least not a full coverage of them, the Government would need alternative sources of information. If wrong-doing was not suspected, it could only be discovered by random spot-checks which we would not recommend. But we believe that individual complaints, press comments, and tip-offs from rival firms, would provide the investigation and prosecution service with ample material.

#### An Ombudsman

- 13. A possible compromise might be to establish an Ombudsman. It is important to be clear exactly what is proposed.
- 14. One role for an Ombudsman would be as a modification of the Gower approach. On the Gower proposals, appeals from SRAs go to the CSI or to the Department of Trade. But the CSI is widely believed to be inadequate for this purpose, and there must be doubts over its continuing existence. And we would obviously like the Government's role to be as limited as possible. Hence the suggestion of an Ombudsman standing between SRAs and the DTI as part of the appeals procedure (it could even displace the DTI entirely). If the Gower route were adopted, this might be a desirable improvement on it, but it is so close to Gower as hardly to represent a compromise with the minimalist approach.

Another possibility would be to use an Ombudsman as an optional supplement to our preferred approach outlined above. Individuals who felt badly treated by financial institutions would complain to the Ombudsman who would operate separately from the official prosecuting service. He would have a legal power to call for evidence, and would establish whether simply a bad investment decision had been taken, or whether there was genuine misconduct. If it was misconduct, he could suggest a penalty which would be voluntarily paid by the institution involved. But if the offence was serious or the institution would not comply, he could then pass the papers on to the prosecuting authorities. The Ombudsman would therefore act as a filter for some complaints which would otherwise go direct for criminal investigation; and by encourage voluntary provision of information.

#### Conclusion

The Gower approach has considerable risks; in particular it could encourage the view that Ministers and Departments will bear ultimate responsibility for investment decisions. The minimalist approach set out above avoids this problem. It much more accurately reflects the duties which Ministers and officials can successfully take upon themselves. We are sceptical of the supposed objections to this approach. But if it was felt that the official investigations might be too heavy-handed, and that insufficient information would be available to the Authorities, an Ombudsman might be a way of dealing with this problem.

DLW DAVID WILLETTS



JF6371
Secretary of State for Trade and Industry

NOPM AT 26/4

# DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET LONDON SWIH 0ET

Telephone (Direct dialling) 01-215) 5422 GTN 215) 5422 (Switchboard) 215 7877

26 April 1984

Andrew Turnbull Esq Privaté Secretary to the Prime Minister 10 Downing Street LONDON SW1

Dear Andrew

THE STOCK EXCHANGE AND THE GOWER REPORT

The Secretary of State has seen your letter of 10 April.

- 2 Mr Tebbit is glad that The Stock Exchange's consultative document found favour with the Prime Minister. He too found some of the options commendably bold. The Stock Exchange authorities are actively exploring the technological requirements of changing the trading system. Officials in this Department have regular meetings with officials of The Stock Exchange and of the Bank of England for monitoring all aspects of the reform set in train last summer.
- 3 Mr Tebbit understands the Prime Minister's concerns about the proposals in the Gower Report, and will take account of them when he considers and reviews the comments received on the Report, for which the closing date is 30 April.
- 4 Copies of this go to David Peretz (Treasury) and Tim Allen (Bank of England).

RUTH THOMPSON Private Secretary Rowlow i comes for Nov 83

File a linear Protect



NOTE OF SPEECH BY LORD HARRIS AT ANNUAL LUNCH OF UNIT TRUST ASSOCIATION: 12.4.84

Recall story of F.E. Smith: Lion in a den of Daniel's.

Venture to criticise Gwwer and all that; good press - highly suspicious!

Richard Lambert in Financial Times recently was first to voice doubts that unanimous approval might mean everyone is 'completely, utterly, 100% mad'.

Then came attack from Sir Walter Salomon 'the sergeant major of the awkward squad'.... denounced Gower as 'unworkable', 'costly", 'bureaucratic' and 'damaging to individual freedom'.

I claim no detailed knowledge of Gower and financial complexities... Instead
would in broad terms indicate the dangers of uncritical support. Gower's
central assumption is that best way to protect investor is to restrict
competition. Regulation or self-regulation to include straight cartel
practices, such as fixing prices and commissions and imposing barriers to
entry of new firms. Various examples in life insurance, industrial assurance, etc.

Recall threefold merits of competition: downward pressure on costs, sovereignty of consumer, and innovation (competition as 'a discovery procedure').

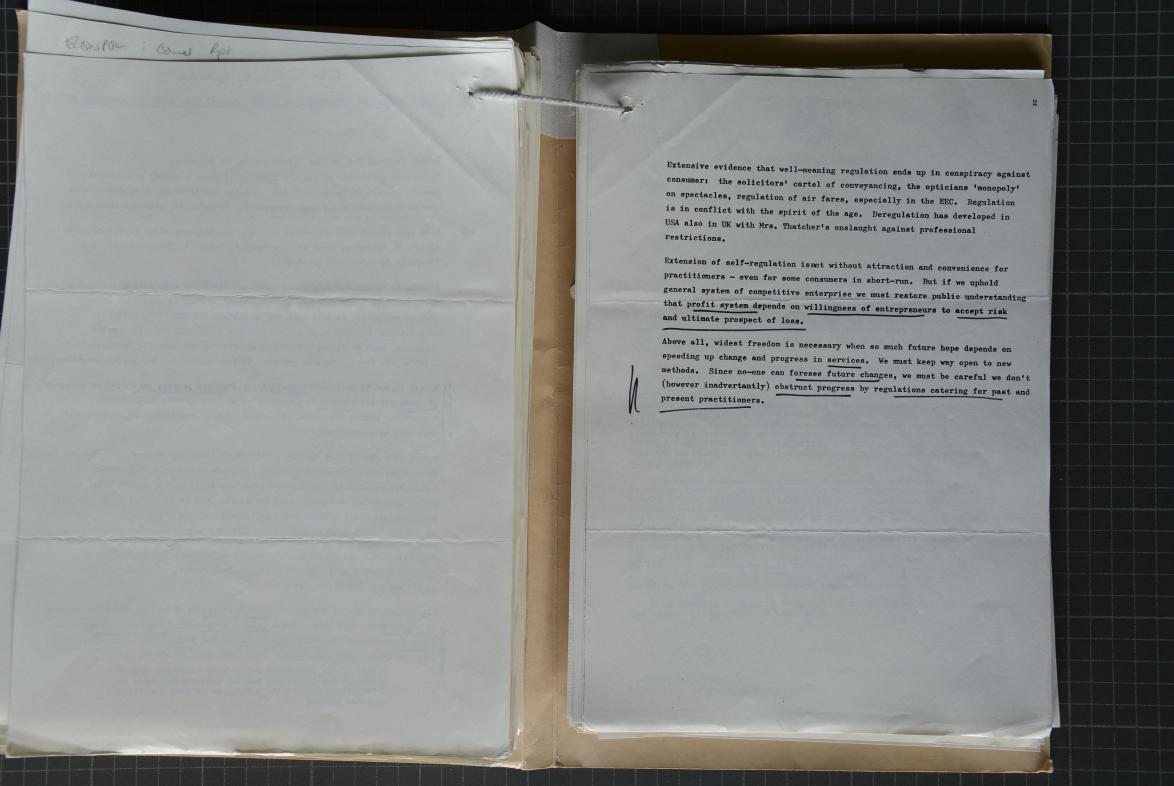
Competitive market imperfect, but overwhelmingly beneficial to consumer and therefore to general public.

Agreed competition must operate within legal framework to prevent force and fraud. Seems clear that Prevention of Fraud Act needs modernising and strengthening, especially penalties. But free society inevitably leaves open a door, or window or crevice to unscrupulous operators, just amour homes cannot be made proof against theft without being as inhospitable as Alcatraz.

More positively, I acknowledge vital role for consumer education - through press, full disclosure, advertising, comparative information and equivalent of Consumer Association's 'Which?'. But in last resort, no substitute for <a href="mailto:caveat emptor">caveat emptor</a> (Margot Naylor).

All economists not in the pay of special interests should be alert to dangers of regulation. They arise from a natural propensity in men and women: the general preference of established producers for comfort and conformity rather than for competition and change. Adam Smith said it all in 1776:

People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices.





byc: J. Romog (W)

#### 10 DOWNING STREET

From the Private Secretary

10 April, 1984

#### THE STOCK EXCHANGE AND THE GOWER REPORT

The Prime Minister has looked out the Stock Exchange's draft consultative document on the future changes to its structure and membership. She has given some thought to the Gower Report.

She welcomes the radicalism of the Exchange's consultative document, which fully justifies the decision to take the case from the OFT and has noted that the document recognises that the end of minimum commissions will in turn mean that single capacity may not be sustained. She has suggested that the Stock Exchange should now move as rapidly as possible to establishing suitable electronic systems for dealing and providing information about deals in readiness for the move to dual capacity. The availability of such information would be the best guarantee of investor protection after the demise of single capacity.

The Prime Minister is concerned about the proposals in the Gower Report. She wonders just how closely the Government should become involved in taking responsibility for the proposed self-regulatory bodies as there is a risk that ultimately the Government could be blamed for any malpractice in the City when it is not in the Government's power to prevent it. She wonders whether the Government's responsibility should be limited to ensuring that the normal laws against fraud, embezzlement, theft etc, are also applied rigorously in the City, to ensuring the clients have sufficient information to be able to take reasonably well informed investment decisions, and to ensuring the separation of client and business monies.

I am sending a copy of this letter to David Peretz (HM Treasury) and to Tim Allen (Bank of England).

(Andrew Turnbull)

C. McCarthy, Esq., Department of Trade & Industry KB

GRA type

MR TURNBULL

MR TURNBULL

9 April 1984

cc Mr Redwood

#### DRAFT LETTER TO DTI ON CITY MATTERS

The Prime Minister has endorsed the recommendations in Mr Redwood's minute of 6 April, and I therefore attach a short draft letter for you to send to Mr Tebbit's private secretary.

DAVID WILLETTS

#### DRAFT LETTER FROM ANDREW TURNBULL TO CALLUM McCARTHY

### THE STOCK EXCHANGE AND THE GOWER REPORT

The Prime Minister has been considering the Stock Exchange's draft consultative document on the future changes to its structure and membership. She has also been following comment on the Gower Report.

She welcomes the radicalism of the Exchange's consultative document, which shows how right it was to take the case from the OFT. Is pleased that the document clearly recognises that the end of minimum commissions will in turn mean that single capacity cannot be sustained. The Prime Minister thinks that it is important that the Stock Exchange now move as rapidly as possible to establishing suitable electronic systems for dealing and providing information about deals in readiness for the move to dual capacity. The availability of such information is, she thinks, the best guarantee of investor protection after the demise of single capacity.

The Prime Minister is the concerned about the proposals in the Gower Report. She thinks there is a risk that the DFI would become too closely involved in taking responsibility for the proposed self-regulatory bodies, at that ultimately the Government would be blamed for any malpractice in the City when it is not in the Government's power to prevent it. The Government's responsibility should be limited to ensuring that the normal laws against fraud, embezzlement, theft etc are also applied rigorously in the City, and to ensuring that clients have sufficient information to be able to take reasonably well-informed investment decisions, and command the sparation of the boundary of the provided of the command of the comma

I am copying  $\psi \hat{l} \hat{s}$  letter to David Peretz (Treasury) and Tim Allen (Bank of England).



#### 10 DOWNING STREET

# From the Private Secretary Pune Minuse

This paper fufiles two ramits (i) it provides a summary of be consultative document which the Stock Exchange with shartly be issuing on its tuture

(ii) It provides a view on the proposals contained in the Gove report, in which Su Walter Salamon Commented in his speed.

Agree ut send a letter to DTI, selling out the case made in John Red words

In all

#### PRIME MINISTER

I attach a summary compiled by David Willetts on the Stock Exchange's position concerning the future of the City.

Many City firms have now constructed links with each other. Clearing banks have bought stakes in broking houses. Merchant banks have bought stakes in brokers and in stock-jobbers. There is a growing convergence between the different types of business. The more advanced players in the game see that they will need:

- (a) retail outlets to sell stocks and shares and investment products to the public;
- (b) brokers to act as intermediaries between the buyers and sellers of stocks and shares:
- (c) jobbers who will be the new market-makers within the institutions, running positions in given stocks and shares and trading with a large number of other market participants;
- (d) a base of investment clients and investment products.

The Government's interest in all this should be confined to what, if any, new regulatory regime should be imposed on the fast-changing City. The Government' is now considering through DTI the sporadic responses to the Gower Report. There are many dangers in accepting Gower, or even some of the variants of Gower now coming in from City sources.

The intention behind Gower of setting up a series of self-regulatory bodies beneath an umbrella organisation with responsibility ultimately flowing back to the Department of Trade and Industry is a dangerous one. It would mean that the Government would start to assume responsibility for all the foibles and problems of the market place. People would expect the Government to offer them redress. People would expect the Government to make sure there were no crooked operators. It is not within the Government's power to ensure either of these things.

The Government's interest should be confined to two things. Firstly, it should make sure that the law governing investment

activities is such that it allows changing businesses to flourish, whilst offering individuals clear protection against fraud, embezzlement and crookedness. It should be a common law matter if a company running somebody's investments fails to keep that individual's money separate from the business's own resources, and then goes bankrupt, losing the lot. It should be a common law matter if a firm buys stock for a client's account at a price other than the market price at the time, or for a reason connected with that bank or institution's own business ends, rather than the interests of the client. Insider trading should also be a common law matter.

Secondly, the Government should ensure that market operations and transactions are as visible and transparent as possible. The Stock Exchange does need an on-line computerised information system linked to all deals in the market place. This is well within current technology, and has been operating in New York for many years. The Government should indicate to the Stock Exchange that it will expect this to take place, and the Stock Exchange should be making all due progress now to make sure the system is ready for the abolition of fixed commissions and the other changes which will take place by the autumn of 1985.

You should not be too worried about the possibility of foreigners coming in and buying up the British financial system. They have shown a certain reluctance to do so so far. They have wisely decided that buying stockbrokers and stock-jobbers at expensive prices now, reflecting the enormous profits they have been making out of their cartelised price system, does not make a great deal of sense. If you do buy such an organisation now, you cannot guarantee that the talented people will stay working for it: you can only guarantee that you will pay a rich price for it. The only assets of most City businesses lie in the people they employ, and these people are highly paid and mobile. The Americans will undoubtedly make an entry to the market in due course. They may make more of an entry through the banking businesses they have already built here, adding on to those some individuals who will be required to trade shares. This is a perfectly healthy development, and not one that anyone should fear.

#### Conclusion

If you agree with this line of argument, you could write to Norman Tebbit supporting the prime need for a visible dealing information system for the Stock Exchange. You could also express caution towards the idea of involving the Government in a sophisticated form of regulation along the Gower lines, whilst stressing the need to have a clear law to prevent theft, fraud, embezzlement and insider training.

JOHN REDWOOD

DRAFT STOCK EXCHANGE CONSULTATIVE DOCUMENT The Stock Exchange are to consult their members about changes in structure and membership rules following the end of minimum commissions. This is the final draft of the consultative document which you, Mr Lawson and Mr Tebbit are being given an opportunity to see before publication.

#### Introduction (paragraphs 1-18)

The Stock Exchange are at last more robust about radical change. The end of fixed minimum commissions means that the traditional division between broker (the agent for ultimate buyers or sellers) and jobber (the market-maker running a book of shares) becomes untenable. The broker will lose income as commissions fall, and he will wish to job as well to make money out of the difference between buying and selling prices for shares. So there have to be radical changes in market structure and the Exchange's membership rules.

#### The Objectives of a Market Structure (Paragraph 19)

The paper identifies three main objectives for any new market structure:

- Liquidity. Investors and issuers of securities need a i continuous two-way market. This points to the preservation of some sort of central market bringing together all transactions. A central market could be electronic rather than one geographical location.
- Investor protection. This depends on proper dissemination ii. of information about market deals as well as supervision of members of the Exchange.
- Natural evolution and balance. A rather vague test which iii. coudy become an excuse for all manner of ills. At best, it means that a sufficient number of firms must be ready and able to operate in the new structure so that it is properly competitive. So they have to be given time to get a large enough capital base, and to acquire the necessary expertise.

### Possible Market Structures for Equities (Paragraphs 20-70)

Several possible structures are examined. The document appears to favour market-makers committed always to buy and sell a specified share up to a certain volume. Their prices are published and they compete with each other for business. In return for undertaking this commitment, they enjoy the benefits which jobbers currently enjoy - facilities for borrowing stock and exemption from Stamp Duty, for example.

Associated issues to be resolved include:

- Inactive securities. Firms might be unwilling to make a
  market in more obscure shares either they must be obliged
  to, or a more limited dealing arrangement accepted.
- ii. Information on trading. Unlike in the US, there is at present no system reporting comprehensively and immediately the prices and volumes at which bargains have been done.

  The document recognises that this will need to change, both so as to help investors in their decisions, and to provide protection.
- iii. Conflicts of interest. One firm could be both making a market in a stock and also be an active fund manager. It is suggested that a fund management operation should be separated from the firm's broker/dealer activities.

#### The Gilt-Edged Market (Paragraphs 71-82)

We have a special interest here - it is our debt which they are buying and trading. The document envisages a system of benefits and obligations not unlike that for market-makers in equities. The Bank would recognise some firms as primary dealers who would make markets and deal directly with investors, as well as with other firms acting as agents for investors. They would take on the obligation of always quoting a buying and selling price up to a certain value for any gilt. In return, they would enjoy certain benefits of a special relationship with the Bank - the Bank would only give them access to tap stocks and might also borrow or swap stocks with them.

#### Membership (Paragraphs 99-127)

There is a delicate balance to be struck here. Member Firms will need a much stronger capital base to absorb the increased risks of making a market in volatile shares. This will require outside capital and links with other financial institutions. On the other hand, the Exchange wishes to be able to discipline and regulate firms dealing on the Exchange so as, for example, to enforce the requirement that a market-maker quotes a buying and a selling price for a stock in fair weather and foul. This points to firms being under the management and control of people who are members of the Exchange. The document envisages, therefore, a system whereby 100 per cent outside ownership by a single non-member can be consistent with disciplining individual members of the Exchange. Thus, while nonmember shareholders might put pressure on a subsidiary Member Firm to break the Exchange's rules, individual members, by yielding to such pressure, would leave themselves open to disciplinary action by the Exchange.

We recognise the case for an interlocking system of membership rules and self-regulation. But it must not become over-elaborate and heavy-handed, nor must it become a barrier to entry behind which a cosy cartel develops. Competition from other firms is the best way of ensuring that any member firm meets its obligations.

#### Conclusion (Paragraphs 128-131)

The ideas in the paper would involve a radical recasting of the Stock Exchange. A lot must be done before the "Big Bang" in the autumn of 1985. In particular, the computer arrangements and support systems of the Exchange need to be totally reorganised. The 31 May deadline for comments from Member Firms is tight. If the consultation process takes much longer, the whole timetable could slip.

D. L. W.

DAVID WILLETTS

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THE STOCK EXCHANGE

A DISCUSSION PAPER

# THE STOCK EXCHANGE - A DISCUSSION PAPER

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### INTRODUCTION

On 24th November 1983 The Chairman of The Stock Exchange wrote to the Members advising them that, following the decision to abolish minimum commissions, he had set up two Co-ordinating Committees of the Council, each chaired by one of his Deputy Chairmen, to consider the future of The Stock Exchange's market system, membership structure and constitution. One Committee's task was to recommend whether The Stock Exchange should change its methods of dealing, if necessary by replanning the market systems on dual capacity lines. The other Committee was asked to review the constitution and membership structure of The Stock Exchange against the background of possible changes to the dealing system and the dismantling of fixed commissions and, if necessary, to recommend changes. This discussion paper embodies the reports of both Co-ordinating Committees and is put forward by the Council for wider public discussion. Responses are invited by May 31st 1984 and should be addressed to J.R.C. Young, Director of Policy & Planning.

#### Objectives

 The theme of the discussion paper is the continuation and strengthening of the central market in securities in the United Kingdom and the Republic of Ireland. The Stock Exchange has PAGE PARAGRAPH

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#### Objectives

 The theme of the discussion paper is the continuation and strengthening of the central market in securities in the United Kingdom and the Republic of Ireland. The Stock Exchange has

provided such a market for over 200 years. The starting point is the proposition that The Stock Exchange is itself an enduring institution. That is how our predecessors saw it and the duty of the present membership is to ensure that the Undertaking continues. This means that whatever the structure of membership, the scale of central services and regulatory functions, and the systems of trading there must be a sound and durable Stock Exchange constitution and central resources of capital, market support services and regulatory competence. The Stock Exchange must actively foster competition and growth in the issuing and trading of securities. But it must also maintain ethical, professional and prudential standards at the highest possible level, preserving a sense of fairness and trust within the membership, in the market place, and in the minds of the investing public. There can be no doubt that great changes are in prospect for the stockbroking and stockjobbing communities; these changes must sustain and enhance the integrity of the U.K. market which has given rise to its high international reputation.

3. It is clearly the wish of the Government and the Bank of England to promote a Stock Exchange membership capable of competing in world markets. The Council shares this aim. In pursuing this objective the Council will seek to ensure the maintenance of a central market and a vigorous brokerage community servicing direct investors, and to avoid the creation of a market dominated by a small number of large corporations. Competition at an

international level should promote growth and prosperity in the  $\ensuremath{\mathsf{UK}}$  securities industry.

- 4. Competition is best ensured by providing the opportunity for participants to strive for commercial success without artificial constraints. One of the first requirements for commercial strength and self confidence is risk capital. Many existing Stock Exchange Firms will need more capital if they are to be able to compete effectively. This in turn requires that the present limits on the acquisition by outsiders of existing Member Firms' equity should be lifted at an appropriate time and that the conditions for the Firms who want to raise capital are as favourable as possible.
- 5. Competition will also be served by allowing new entrants into the market. New entrants will need to be admitted, other than by acquiring the equity of existing Firms, in order to provide additional market-making capability and to avoid increasing competition outside the market. This is a serious factor in the equation.
- 6. A means must be found to allow changes to the membership to evolve without penalising existing Member Firms. New entrants should pay a realistic contribution towards The Stock Exchange's services. These have been built up mainly at the expense and through the efforts of the existing membership, and could not be easily developed again from scratch.

- 7. It must also be a primary aim of The Stock Exchange to promote and maintain high standards, not only of dealing, settlement and information, but of professional conduct, ethical behaviour, and confidence in the market. This means preserving the principle of qualified and accountable individual Members who are required to observe the standards and disciplines of The Stock Exchange. Members must have confidence in each other. Investors must have confidence in those who act for them and with whom they deal, and be able to rely on their probity and skill.
- 8. The Stock Exchange has equally clear objectives in designing and developing any new market structure. The system of dealing must aim for the best possible level of liquidity or depth of market and wherever possible provide continuous two-way trading. Adequate investor protection is of high priority, and the system should be constructed so as to allow flexible development and growth in securities trading. The function of The Stock Exchange is to provide a means for investors to buy and sell securities and to ensure that the market is as liquid as possible. This in turn means that issuers of securities companies and the Government can raise funds at the lowest possible cost. This is a fundamental purpose of The Stock Exchange.

#### Views of Participants

 The Stock Exchange is above all a market. The Stock Exchange's market structure has served well both issuers and investors over

a long period of time. In preparing this paper the Council has interviewed a large number of Members and users of the market. In the time available, consultation has not been possible with every Member Firm nor with all major users of the market but it will continue during the discussion period. Much support for the virtues of the present single capacity system has been evident, particularly for the continuous market provided by the jobbing system. But Members and users have said that single capacity is lost if it does not have the full support of all concerned, and almost everybody doubts that it can survive after the abandonment of fixed commissions. The Council's declared policy has been to maintain single capacity as long as it is commercially desirable so to do, and as long as it is wanted by the users of the market. It is now clear that these two conditions will no longer be met once negotiated commissions are introduced. In the Council's view, therefore, the market structure is bound to change. In short, single capacity cannot last.

10. The major jobbers agree that a change from the present single capacity system is inevitable. They believe that it is essential to make a change at the same time as the introduction of negotiated commissions. Some jobbers say that the dominance of institutional investors has made jobbing difficult in normal times, and that the bull market activity of recent years has masked this fact. This has been exacerbated by the concentration of institutional business in the hands of fewer brokers. Both factors have led to trading losses in leading equities and to the

need for wider opening price spread conventions. This confirms the Council's view that the single capacity system will not last in its present form with negotiated commissions.

- 11. The smaller Firms of equity jobbers would like to retain the existing system if it is possible, but see a position for themselves under a new dealing system as specialist market-makers. Unlike the bigger jobbers, some have said they would not wish to deal direct with clients. There is particular value in the service which smaller Firms of gilt-edged jobbers provide for private client business. These Firms hope to continue to provide a market-making service, whatever may happen to the Institutional market in gilt-edged securities.
- 12. Most of the larger brokers regard the 'link' between minimum commissions and the jobbing system as indissoluble. They believe that, with negotiated commissions, dual capacity is inevitable because it would be necessary for brokers to take positions in order to get business. This would first lead to the need to match business between clients without the costs of a market 'put through' and then to competitive market-making amongst brokers. They say that the Council should plan to introduce a new dealing system at the same time as negotiated commissions start. The brokers most conscious of the problem are those who are attempting to compete in internationally traded equity securities, and who see clearly that they are handicapped by single capacity in competition with overseas houses which are

able to deal in variations of dual capacity. They do not believe that the international nature of the market is simply a short term phenomenon. They do not wish to surrender the domestic market to this unequal competition. They think it is impossible to build a ring fence around the domestic market and they want to compete.

- 13. Representatives of Firms primarily serving private investors recognise the probability of change and do not relish the prospect. They value single capacity and think that private investors' needs are well served by it. Their main concern is that there should be a liquid central market in which they can transact agency business speedily and at a fair price.
- 14. Many institutional investors say that there is much to commend single capacity for the continuity and liquidity it provides and for the way conflicts of interest are naturally minimised, but question whether it can survive indefinitely in the new more international environment. They argue that The Stock Exchange's primary responsibility is to provide a liquid and continuous market. If the market does not work well, business will move elsewhere. Some, but by no means all, say that the jobbing system no longer provides the degree of liquidity which they need and that they could not support the maintenance of the single capacity market if they were offered a more competitive service from outside houses, or immediate deals at net prices from Stock Exchange Firms wanting to act in dual capacity. There is no

doubt that most investment managers have become familiar with the use of different dealing systems overseas in recent years, and are growing accustomed to trading in securities with principals. Institutions, however, hope to continue to receive the same unbiased investment advice which they have enjoyed until now.

#### Conclusion

- 15. On the basis of these considerations the Council therefore takes the view that the dealing system must change and that any new system must be available by the time minimum commissions are dismantled. In consequence, the present membership and entry rules will also need to change, within the same timescale, and the structure and constitution of The Stock Exchange must be adapted as far as is necessary to accommodate these changes. Most Members assume that outside houses will in due course be admitted to Stock Exchange membership in some form, in order to prevent fragmentation of the market. This is also the view of the Bank of England.
- 16. Certain precepts should be taken as read. The need for investor protection is axiomatic. Listing standards will continue to provide a common level of information. Disciplinary arrangements will be based on individual membership. Qualifying standards will continue to be set for the entry of individual Members. There will continue to be supervision and inspection of Firms, backed by compensation arrangements.

- 17. However, the burden of regulation to enforce these principles will inevitably be heavier. Separation of capacity induces commercial practices which work to the best advantage of the investor. Dual capacity does not provide the same degree of self-policing and it would therefore have to be reinforced by more regulation. Self-regulation will be put to the test and the Council accepts the need to allocate sufficient resources to meet this challenge.
- 18. The remainder of this paper deals firstly with the market structure and secondly with the membership arrangements.

#### The Objectives of a Market Structure

- 19. The main objectives of any new market structure for the UK should be:-
  - 19.1 The optimum degree of liquidity. The availability of continuous two-way trading in reasonable size is important both to investors and issuers of securities. Investors should be able to deal in reasonable size as buyers or sellers and be able to rely on the prices they find. The market structure through which the prices of securities are formed should permit continuous dealings and encourage the highest possible exposure of orders to each other. Continuous liquid markets and sensitive price formation are of importance to issuers, who should be able to rely

on the market's prices when pitching their issues of new securities, and be assured of adequate liquidity to support subsequent dealings by investors. An efficient and liquid market allows issuers to raise new capital more cheaply.

- 19.2 Adequate investor protection. A market structure cannot in itself guarantee investor protection, which rests in part upon direct supervision and inspection of Member Firms, adequate compensation arrangements, surveillance of market transactions and proper procedures for investigating complaints by investors. The system of dealing should, however, be constructed so as to minimise conflicts of interest and to ensure that bargains are made at fair market prices. Access to the market should be open to all classes of investor through Member Firms and dealings should be as visible as possible. The market must be attractive to private investors and safe for them to use.
- 19.3 Natural evolution and balance. Market participants of the type found in other financial centres cannot be conjured into being at the stroke of a pen. It would be unrealistic to suppose that, simply by writing the appropriate rules, The Stock Exchange can create a dozen auction/ specialist Firms in the US mode, accepting complex market functions and capable of making a respectable return on

capital. Nor can new competing market-makers be created by edict. Different types of Firm may evolve, but the market framework itself cannot immediately create them. The Stock Exchange should concentrate on defining responsibilities and privileges, and provide encouragement to liquidity and competition, with conditions for open and fair dealings. These aims may be in conflict however. In particular, Firms which take on the risks of market-making need to have clear incentives for doing so. The market structure must be a commercial proposition for all the participants. All Firms are likely to have obligations to the market in one form or another and there must be a generally acceptable balance of privilege and obligation.

#### POSSIBLE MARKET STRUCTURES FOR EQUITIES

- 20. The US Treasury Bond market is a useful model from which to begin to delineate a suitable dealing system for gilt-edged securities, and the Council's view of the outlines of such a system is given in paragraphs 71 to 82. For UK company securities, however, it is easier to describe the objectives of a new market structure and to establish the framework in which it must be set than to articulate a clear definition of its best form.
- 21. Moreover, it is less apparent, in the case of the UK equity and company fixed interest market, that changes to the market

structure would promise an equivalent level of liquidity to the present system, at least in the early stages. The great variety of securities listed, varying from those which are very active and of international interest to those which are dealt infrequently, and then usually in smaller amounts, does not make it easy to conceive a single and unified system of dealing. The familiar advantages of the jobbing system are noteworthy in this respect, and will be hard to replace in a new system.

- 22. In the earlier stages of change to a new system of dealing, therefore, some reduction in liquidity will almost certainly have to be expected, especially in less active securities. This would probably be the case whatever system or combination of systems is adopted. In time, as practitioners become used to different market procedures and to the assumption of new and possibly unfamiliar commercial roles, confidence should return and liquidity improve. Any new dealing system will suffer from growing pains of this sort, and in the Council's view it will be vital to construct any system with the primary aim of encouraging the confidence of members of the market, particularly of those whose function it will be to provide liquidity. This need has strongly coloured the Council's thinking so far, and will be referred to again at several points in this section of the paper.
- 23. The starting point for a new structure is the repeal, at the appropriate time, of the present single capacity rules. In the

absence of these rules, or suitable replacements, there would be little to hold the market together. There would of course be commercial pressures: for example, those with stocks to sell would advertise the fact, while those companies with stocks to issue might ask their issuing house to make a market. In time a new market might grow, but this in itself cannot be enough. Some stocks might be easy to buy and sell, but others would not certainly not all of the time, as Members might quote prices only when it suited them and, when conditions turned difficult, no one would want to make continuous markets. The market at any one time might be difficult to find: it might be on the floor, or it might be in an upstairs dealing room where a large block was being put together. A Stock Exchange Member would have no way of knowing. If he did find out, there would be nothing to ensure that his client benefitted from his discovery, since he would be under little regulatory pressure to pass on the best price when he found it. Such an anarchic market is clearly not tolerable, and a more structured system must be devised.

24. Successful dealing systems for active securities tend to fall into two broad categories: those which are based on the principle of a broker-to-broker auction market, with specialist participants whose specific role it is to assist the market process, if necessary by supplying bids and offers when they are needed; and those which rely on competing market-makers, whose obligation it may be to make committed two-way prices. The

jobbing system is a unique variation of the second type. There are successful systems in both categories, and typically the functions of market participants may be restricted in various ways, and their obligations to the market defined and regulated to a greater or lesser degree. Different means of providing institutional encouragement of liquidity may be built into either type of dealing system, and the market structure itself may or may not engender a level of natural protection for investors. Similarly, one system may naturally promote centralised trading, and another may require regulatory arrangements to achieve it.

- 25. The Council will continue exploring the merits of several possible approaches and will welcome further consultations with, and submissions of preference from, Members and users of the market. They will be assisted in their deliberations by a panel of expert and representative market practitioners.
- 26. The choice has so far appeared to lie among the following possibilities:-
  - 26.1 A loose, unrestrictive form of competing market-maker system, where all Firms are Broker Dealers free to deal with counterparties or clients in any capacity, or to market-make, provided that their capacity is disclosed, their market-making prices are made public and the details of their transactions are immediately published to the

market. There is no order exposure requirement in this model.

- 26.2 An extended form of 'separate capacity' dealing system based again on Broker Dealers who may act as competing market-makers; Member Firms are free to deal as market-makers or agents subject, primarily, to the strict stipulation that orders solicited or received in an agency capacity must be executed as such, and not in a principal capacity, and may not be executed with the Firm's own principal's book.
- 26.3 An auction, or broker-to-broker market on the floor, relying on some form of specialist function appropriate for the UK market, where Broker Dealers may also arrange business amongst clients and take principals' positions, providing that all such transactions are crossed with the specialist.
- 26.4 A more restrictive competing market-maker system, where those who wish to be market-makers undertake, in return for certain privileges, to make continuous two-way prices and are benefitted by an order exposure rule applying to Broker Dealers who are not market-makers, but where all Firms are permitted, under regulation, to deal as agent or principal with clients.

# A Competing Market-maker System with no Order Exposure

27. The Council has not so far favoured the first approach (26.1). An unrestricted or 'free' form of competing market-maker system would serve to encourage the provision of liquidity by fair weather traders. Provided that a substantial number of such traders were in active operation and prepared to deal with other Members, indicating their two-way prices to the market, and agreeing to the publication of all their transactions immediately, a substantial level of visible market activity might develop. However, it can be argued that such a market would suffer from the disadvantage that trading would be fragmented and decentralised. Clients' and professional orders would tend to be dealt privately off the dealers' books and instantaneous reporting of trades would be the only formal protection against the unsophisticated investor's order being executed at an unfair price. Furthermore, since there would be no order exposure requirement there would be no opportunity of market intervention in such dealing activity. In the absence of any commitment on the part of dealers to make prices in reasonable amounts in fair weather and foul, market liquidity in inactive or unattractive securities could be seriously deficient, especially when trading conditions were poor.

## A Separated Capacity System

28. Similarly, reservations must be placed against the system of separated capacity (26.2). Strict separation of dealing

capacities provides protection to the investor who, by this measure, should be clearly aware whether or not a broker is bound by agency responsibilities and duties, and free from the conflict of interest inherent in dealing with his own Firm's principals book.

Under this system, any firm would be free to deal either as principal or agent with a client provided that the client was aware of the capacity in which the Firm was dealing. Agency orders could be executed by matching them with agency orders the opposite way or by dealing with another Firm registered as a market-maker in that security. Alternatively, with the client's agreement, the Firm could deal with the client as principal in the whole or part of the order, undoing the transaction as a principal with another client, or with a market-maker. Some Member Firms might wish to accept the obligations of continuous price making by registering as a market-maker in specific securities, in return for stamp duty, stock borrowing and other privileges, and in that capacity would be also able to deal as principal with its own clients but would undertake to make two-way prices to other Member Firms.

This system would be an improvement on the looser form of competing market-maker system outlined above, since there would be a better chance of some commitment from market-makers and clear identification of the capacity in which a Firm was dealing. It would not be envisaged that information on last trades would be published, but full reporting of transaction

details to the Stock Exchange Authorities would be mandatory. It could be a requirement that business matched in an agency capacity was immediately published. A criticism of this system would be the absence of regulation to ensure that market dealings were centralised and not conducted privately in Member Firms' offices. In this respect it suffers from the same defect as the system outlined in paragraph 27 above. There would be no opportunity of intervention in matched agency transactions, nor in principal trades between a Firm and its clients.

# An Auction System with Specialists

- 29. Block trading business, where a Broker Dealer seeks matching orders for institutional sized orders, is prepared to quote a firm price to the originating client and if necessary to position against all or part of the order if he is not able to find matching orders, is an important activity in the New York Stock Exchange ('NYSE'). It combines well with a centralised floor auction market where such transactions must be brought to be crossed in front of the specialist and the floor market's requirements can often be fitted into the transaction.
- 30. Accordingly, an auction system (26.3) based on the type of market arrangement in the NYSE has merits. However, it is arguable whether the advantages of such a system outweigh its disadvantages in the UK context, where the variety of securities listed is far wider than in any auction market in the U.S.A. In

particular, there must be considerable doubt whether it would be suitable other than for active securities. Sporadic dealings in infrequently traded securities do not naturally lend themselves to a broker-to-broker floor market system.

- 31. The Council will continue to examine the idea of introducing an auction system for dealing in active securities. It should be remembered, however, that this system has limitations, particularly where there is a marked imbalance of supply and demand and where the capital of the specialist is limited in relation to the volume of business 'one way'. Some of its other disadvantages are noted below.
- 32. The chief responsibility of the specialist in an auction market is to ensure that there is always a 'floor quote' (and that this quote is on or within a 'spread' specified by the Exchange) by entering on his own account a best bid or best offer or both when none have been otherwise entered. The specialist, who will look after a list of stocks, has an obligation to ensure a continuous market, to manage public limit orders, to maintain an orderly market between brokers dealing directly with each other at his pitch, to authorise 'crosses' (intervening when necessary for public limits), to ensure last trade reporting and to be responsible for setting an opening price and clearing orders at the opening. The system can only work during market hours. There is need for strict and complex regulation of specialists, including control of the circumstances and prices at which they

participate in the auction on their own account. The business of the specialist has to be completely separated from the activity of any related Broker Dealer, and the great majority of specialist firms in the NYSE have no other activity, and are unrelated to other firms in the securities industry. It is questionable, therefore, whether such a role would be likely to appeal to many existing Firms.

- 33. It is possible that the specialist function might appeal to some of the present jobbing Firms, provided they were permitted to conduct other activities in separate parts of their organisations. The Council could request the present jobbers to assume the role of specialists on the floor, in separate subsidiaries, and require them to fulfil some of the functions of the specialist in the New York system.
- 34. In particular, they might be expected to retain public limit orders in their assigned securities and see to it that they were entered into the auction process, to look after agency orders left with them by Broker Dealers on the floor, and to execute them by matching with other brokers' orders or where appropriate as direct counterparties themselves. They would be responsible for authorising 'block trade' business arranged in Broker Dealers' offices which would be crossed on the floor. They would also handle business accumulated at the beginning of the day's trading period, setting an appropriate opening price and matching orders against each other. Such an arrangement of floor

specialists would of course satisfy the need for centralised trading.

- The extent to which such a specialist role should be restricted would need to be carefully considered. The specialist in the New York system performs a neutral function in that he does not compete against brokers' orders which are dealt in the crowd broker-to-broker, and does not intervene in trading activity except in closely defined circumstances and at regulated prices. It may be that in the U.K. the specialist could be allowed to adopt a role more akin to jobbing and be allowed to take larger and perhaps more speculative positions and deal for his own account in size outside the 'touch' price. It is also for discussion whether a specialist role in the UK should be completely separated from the business of a parent Broker Dealer, as is broadly the case in the New York system. There might need to be a Chinese Wall so that Broker Dealers during market hours remained unaware of their related specialists' positions and the latter did not retail their book positions through their Broker Dealers during such hours. It would also be necessary to introduce immediate last trade publication in the securities dealt in this system.
- 36. The adoption of such a system would have certain practical disadvantages. It would involve very different and unfamiliar floor trading techniques, and complicated forms of market support, regulation and surveillance. The market could operate

only during floor trading hours, and there would probably need to be new electronically assisted systems for ordering and handling business at the opening of trading and regulated arrangements for off floor dealing outside market hours. Settlement would be a problem. The Talisman system can be adapted to handle business in a competing market-maker system of trading where the number of market-makers in each security is relatively limited, but the problem of satisfactorily settling business between more than two hundred Firms dealing broker-to-broker would require major adaptations of the present settlement system, which could be made only in the longer term.

## A Competing Market-maker System with Order Exposure

- 37. A centralised market containing committed market-makers (26.4), would appear in principle, on the other hand, to have advantages that may outweigh its drawbacks, and since it is nearer to the present system would allow natural evolution to proceed more easily. A rather more detailed illustration of this possible approach follows.
- 38. The first requirement of a competing market-maker system is a means of communication between those who are making markets, wherever they may be, and those who wish to deal: a system for relaying dealing prices amongst members of the market. This could take the form of a Quotation Dissemination System (QDS). Such a system would carry the market-makers' competing bid and offer quotations, and would be available only to Members of The

Stock Exchange, who would therefore have exclusive knowledge of the state of the market - just as, at present, only Members may walk on to the floor. This would be a benefit of membership. The jobbers have always been unwilling to allow continuous publication of their two-way prices and are firm in the belief that visible changes in their bid and offer quotations can reveal the profile of their books. Nevertheless, in a competing market-maker system where the market-makers are not necessarily collected in a single place, Members will have more need for a detailed display of competing quotations, and it follows that market-makers should show their bids and offers to all other Members. The Stock Exchange would also make available, to non-members, a continuously updated mid-price or, perhaps, a two-way 'touch' price drawn electronically from the QDS.

- 39. Information on market-makers' bid and offer quotations cannot alone ensure a liquid and continuous market. If there is to be continuous trading, market-makers must be prepared to commit themselves to make firm two-way prices in reasonable amounts.
- 40. Those who took on this obligation would expect compensating privileges. These might include the following:-
  - 40.1 The market-makers would be able to enter two-way quotations on the QDS.
  - 40.2 The market-makers would have the various privileges now available to the jobbers, including their settlement

facilities, the stamp duty concession, stock borrowing facilities and the special arrangements for 'netting', for tax purposes, dividends arising from their bull and bear positions.

- 40.3 Broker Dealers would be required to transact business in normal marketable quantities only with the market-makers.
- 40.4 Market-makers would have some protection, in the form of an order exposure rule applying to Broker Dealers, against business in large amounts being arranged without taking account of market-makers' positions and outstanding public limit orders.
- 41. If Broker Dealers were to be allowed to arrange business between clients and take principals' positions against their clients it would have to be ensured that such business did not take place without some opportunity for a market-maker to intervene for orders which he held. Without such stipulations the market would rapidly become fragmented and market-makers would wish to withdraw from their commitments and become fair weather traders. If the market is to be kept centralised, some level of order exposure by those who were not market-makers would be essential. It should also be borne in mind that the exposure of orders to the market protects the client, who is entitled to some reassurance that his business has been executed at the best commercial price. It is vital that this market structure should be

constructed so as to give adequate encouragement to Firms to come forward as committed market-makers in fair weather and foul, and to ensure that dealings are exposed as much as possible to each other. At the same time it should not unduly inhibit the provision of additional liquidity by Broker Dealers, who may be prepared to take principals' positions to facilitate the business of their clients, and will expect to be able to place stock with other clients with the minimum of interference. The balance of these objectives is delicate and deserves careful consideration by market practitioners before final conclusions can be reached.

- 42. In the market structure illustrated here, there would be a single class of Firm, the Broker Dealer. A Broker Dealer Firm would be able to register as a market-maker in any security, as jobbers do now. Once registered, a market-maker would be oliged to stand ready to make continuous two-way prices in that stock in reasonable 'official' size.
- 43. Market-makers would have to be adequately capitalised for the business they did, and the Council would lay down the necessary criteria. The Council would also set standards and monitor the dealing spreads and general performance of registered market-makers and have the power to de-register them if they did not match up to their market-making or capital obligations.
- 44. A Firm registered as a market-maker in a security would be expected to enter on the screen, and continuously update by means

of a terminal keyboard, a bid and offer price which was firm to all Members for a reasonable, official amount. The amount would be regulated by the Council and might be shown on the screen. Each registered market-maker might also publicise or otherwise make it known that he was 'normally good for' a specified amount which was greater than the official amount. So the quotations a Member might see on the screen would be firm for the official amount and there might be indicative quotations or knowledge in the market of the market-maker's 'normal amount'.

45. In order to provide the market-makers with an adequate incentive to make continuous liquid markets it would be an obligation of the Broker Dealer Firms who were not registered as market-makers to execute with the market-makers all transactions up to normal market size. The Stock Exchange would publish a register of these sizes. Such business would normally be dealt in an agency capacity by the Broker Dealer, and governed by the rule that he must always deal to his client's best advantage. Market-makers would not be allowed to deal direct with clients in bargains up. to the same size, which would be brought to them for execution under the best advantage rule. Some practitioners may argue that if a client wished to be quoted an immediate net price in a normal marketable amount, the Broker Dealer or market-maker should be able to do this. In that case, the resulting principal position might need to be undone with an official market-maker; otherwise market-makers might see only a fraction of such business, and the market would be fragmented. This is for further examination during the discussion period.

- 46. In transactions over the market-makers' normal market size a Broker Dealer would follow an order exposure procedure. One method could be as follows. Where a Broker Dealer wanted to negotiate an order which he intended to match with other clients or position against as a principal, he would be obliged to satisfy himself through his knowledge of the market that there was no better price in that size among the market-makers than the price at which he was prepared to underwrite the order as a principal himself. He would then be able to propose to the client that the business should be handled as a 'special deal' or block trade. This would imply that he would not seek to deal with a market-maker but would obtain matching orders amongst his clients and if necessary, take up himself any uncompleted part of the order at the agreed price as a principal. He might indeed agree to take the whole amount. In either case he would make the client a firm price. He would then be able to approach other clients but, before finally completing this side of the transaction, he would be obliged to offer the leading marketmaker the opportunity to satisfy limit orders left with him and perhaps to sell or take sufficient stock to balance the bull or bear position on his book in that security.
- 47. The Broker would be free to deal in a further part of the order with the market-maker at that stage if he wished to preserve goodwill, but his only obligation would be as above. It should be understood that although limit orders are not, at present, common in the UK market they might become so under such a system

as this, and the Council would then consider developing a computerised central limit order book, which would hold such orders and permit display of the amount of firm public interest known to the market-makers at various prices. Limit orders would be satisfied under this system only if they were left with the market-maker before the initiation of the order and not while the Broker Dealer was attempting to match the business.

48. The level of order exposure illustrated in this example is limited. The Broker Dealer would have offered the leading marketmaker the chance of intervening. He would not have been required to disclose the business more widely nor to tell the market-maker whether he was keeping some or all of the stock on his book rather than placing it. The disadvantage of imposing too strict an order exposure rule on Broker Dealers is that market-makers would often be competitors and might be in a position to frustrate the Broker Dealer's business. The completion of matching business by Broker Dealers must not be frustrated to an extent which prejudices the depth of the market in general. If exposure to a potential competitor - a market-maker - is unacceptable to Broker Dealers, it might be possible for market officials to be responsible for limit orders. Block trades would have to be 'crossed' with this official in the same way that trades are crossed with the specialist in New York. The prime aim must be to maintain a centralised market and an efficient market-making sector. For this reason an appropriate level of order exposure would have to be worked out and enforced.

- 49. In this system, in effect, the underlying presumption within the market would be that, unless otherwise agreed with the client, orders placed by clients' with Broker Dealers would be agency orders and the Broker Dealer would be obliged to deal to his client's best advantage. Such agency orders would be executed with the market-makers, at least where they were within normal market size. Subject to the order exposure rule, larger orders could be matched with other clients or retained on the Broker Dealer's principal's book. In all cases the Broker Dealer would be obliged to disclose to his client at the time of dealing the capacity in which he had dealt. All of these arrangements would have to be made explicit in the rules and appropriate monitoring procedures established.
- 50. It should be noted that the order exposure rule described above is not carried to its logical conclusion, namely that the market-makers themselves should expose their business to other market-makers or to a market official. Such a requirement might be an overwhelming deterrent to the emerging market-making system and could seriously jeopardise its potential liquidity. However, market-makers would be entitled to deal direct with investors in large amounts as principals, with other market-makers and with Broker Dealers acting both on their own account and as agents, seeing in particular all normal sized business. It is for further consideration by practitioners whether, in the arrangement illustrated here, the balance of advantage has been swung too far in favour of the market-making sector; or whether,

in spite of the advantages suggested, insufficient Firms would want to take on the role of market-maker.

# Market-making in Inactive Securities

- 51. The aim of the suggested system so far described is to strike a balance between the need for centralising the market and for achieving optimum liquidity. There must inevitably be doubt whether market-makers will be encouraged to register, in spite of the incentives and privileges granted to them. In particular, it must be expected that there would be some securities in which no Firm was prepared to register as a market-maker. In these cases, of course, the difference between the best bid and lowest offer in the market at any given time might be enough to attract market-makers to extend their list of registrations. Other Broker Dealers (perhaps brokers to the company, or regional Broker Dealers) would also be encouraged to register. But to the extent that no Broker Dealer applied for registration in particular securities, The Stock Exchange would have to make or allow other arrangements.
- 52. The Council might consider insisting that the market-makers registered in major stocks undertook to share the role of making markets in 'unattractive' securities. Failing this, it should be noted that The Stock Exchange would be unlikely to be able to guarantee a minimum of two market-makers in every security traded on The Stock Exchange, as is now the case in the jobbing system.

However, it would always be the Council's intention to ensure that there was an adequate market in all new securities brought for listing, or into the U.S.M.

- 53. An arrangement for inactive securities would, in any event, be required, which would help to assure those who wish to trade of some opportunity of finding a counterparty. Broker Dealers could be allowed to register as 'Accredited Dealers' in securities for which there was insufficient activity to attract committed market-makers. Such Firms would not be obliged to make and publish a continuous and dedicated two-way price in the stock but, at the least, would publish their names and telephone numbers on the QDS and be prepared to take calls and negotiate with Members seeking to deal. They might be permitted to enter on the QDS their last dealing price, or their indicative bids or offers, if they wished to attract calls.
- 54. It might be a rule of The Stock Exchange that if dealings were maintained at a certain level for a certain period the Accredited Dealer would be obliged to register as a fully dedicated market-maker in that security. The Council would monitor the quality of the Accredited Dealer's market-making service. The Council would pay attention to the period of notice to be required of a Broker Dealer wishing to become registered as a market-maker. Market-makers would be more likely to register in the first instance in securities which were generally inactive if they were confident that when there was a burst of activity in the stock there would not be an immediate influx of other market-makers.

- a Broker Dealer would have to be allowed to deal with his client as principal or to match with other clients but only at a price he would be prepared to justify in relation to the last officially recorded trade price and to current market conditions. He should also expect such transactions to be carefully monitored by the Stock Exchange authorities. At the same time, the Broker Dealer might be allowed temporary registration as an Accredited Dealer to invite enquiries, but in that case he would normally have to be prepared to deal with other Members for as long as he remained registered. He would perhaps be afforded the facility of posting indicative prices on the QDS. As mentioned above, strict rules to control entry and withdrawal from temporary registration would be applied.
- 56. The Council would, in addition, examine the feasibility of electronic matching of limit orders in securities where no regular market-making function emerged.

# Review of the Possible Dealing Systems

57. The competitive dealer market which has been described is nearer to the present system in concept and practice than an auction market, which is in reality the only other kind of system, apart from jobbing, which allows continuous dealing. Like an auction market it is centralised, with an integrated quotation system and recorded information on trading activity. Whilst lacking

immediate publication of the details of trading activity, it may encourage the emergence and viability of a market-making sector. The extent of any order exposure requirement will need to be worked out with participants.

- 58. A competing market-maker approach offers a market-based solution to the problem of the widely varying frequency with which different sized securities naturally trade in London and the provinces, without the need to adopt fundamentally different trading methods for different classes of securities. The liquidity of particular securities will be reflected in the number of Broker Dealers willing to register as market-makers in them.
- 59. Another way of approaching the problem would be to consider adopting different trading systems for different categories of security. A form of auction market containing specialists with immediate publication of last trade information might be appropriate for the most active securities and satisfy the need for centralisation and investor protection in such securities. A committed and competing market-maker arrangement could be more suitable for less active or second tier securities and could also achieve adequate centralisation and investor protection. An electronic system of limit storage and direct matching of orders might ultimately be the best solution for the least active securities in which no market-makers were prepared to come forward and for which an auction/specialist system would be quite inappropriate.

60. There are obvious practical difficulties in tiering the market in this way, but it is a possible alternative, given the natural range of marketability amongst different types and sizes of security in the UK equity and company fixed interest market; there may be valid arguments for achieving the most flexible combination of systems. Comments of market users will be welcome. The Council's present view is that it would be preferable, if at all possible, to introduce a system capable of unifying the trading market in a single system and avoiding the need for different market functions, complex regulation and surveillance procedures and additional technical systems for each tier of the market. In the long run, of course, it may be possible to develop electronic systems which will unify trading practices in a common automatic market system. It should not be assumed that such an approach is practicable in anything but the longer term. It should be noted that central settlement would continue to be mandatory in the UK equity and company fixed interest market whatever dealing system is employed.

#### The Floor

61. Under a specialist system, the floor would of course be used for dealing but the compatibility of a competing market-maker system with floor dealing in the long term is questionable. Jobbers have valued the informal communication of 'market feel' across a floor, and have always maintained that information on the state of the market is peculiarly available through face-to-face

dealings. It is possible (although by no means certain) that, to begin with at any rate, former jobbers would prefer to maintain their market-making operation on the floor during market hours. On the other hand new market-makers might wish to deal from their offices over the telephone. The Council wishes to preserve flexibility. It is for further discussion whether market-makers should, in the first instance and while the QDS is settling down, be asked to market-make on the Floor during market hours.

### The Publication of Information on Trading

- 62. The Council recognises that in a dealing system which allows

  Firms to combine the functions of agent and principal, the

  quality and quantity of publicly available information on trades

  will need to be enhanced.
- 63. In North American auction markets, the last trade tape is always cited as a necessary adjunct of the dealing system and is said to have the effect of increasing confidence and interest in the market. If a new dealing system were based on the auction principle, publication of last trade information (i.e. price and size of each bargain) could be accommodated without risk to the liquidity of the system. In a system of competing market-makers, however, the publication of last trade information can be inimical to liquidity. Market-makers could be inhibited from registering at all or, in any event, from taking large positions once they were registered. Even if prices alone were revealed

and not volumes, there would be a deterrent to liquidity if the number of market-makers were few in number.

- It should not be supposed that investor protection in a competing market-maker system uniquely depends upon the immediate publication of last trade information. Until quite recently it has been the exception rather than the rule in the highly successful NASDAQ system in operation in the USA. Before 1982 there was no last trade reporting in that market system. It should be noted that the average number of market-makers in the securities where disclosure is now mandatory is over a dozen. The case for full and immediate disclosure of last trade information needs to be considered alongside the other elements of the chosen market structure that may contribute to, or detract from, investor protection and liquidity. In this context the extent to which an explicit agency function is preserved within the dealing system may be particularly relevant, as may be the related question whether Broker Dealers acting as principals are obliged to expose their business to limit orders.
- 65. Providing order exposure in a competing market-maker system is feasible, the Council believes that publication of full last trade information on an instantaneous basis would have to be deferred at least until an adequate number of market-makers had come forward and were dealing with confidence. If an acceptable method of order exposure cannot be decided on then some form of last trade publication may be necessary, notwithstanding that liquidity may consequently be reduced, as a protection against

orders being wrongly executed at a price out of line with the market.

- 66. It should be emphasised that full chronological reporting of transaction details to The Stock Exchange would be mandatory under any system. An adequate degree of investor protection could be assured by the central monitoring of recorded continuous bid and offer displays against these timed and recorded transaction records.
- 67. The Council believes that, whether or not last trades were published immediately, there would be a need for more information on trading to be available to the public. At present the Stock Exchange Daily Official List reports the prices at which bargains have been done, but not comprehensively, not immediately and without any indication of size. The question is how quickly this can be improved. It should be possible to enhance the provision of trade information, both to help investors in their decisions, and to provide a further means of protection. The Stock Exchange Daily Official List could be developed to provide a better public record of business done. It would no longer be permitted to withhold bargains from publication in the Stock Exchange Daily Official List. In addition, it should be possible to provide for an electronic display of transaction prices and volumes in chronological order on a daily or weekly basis (as well as a printed record). This might then further enhance interest in the market, with a beneficial impact on turnover.

### Conflicts of Interest

- 68. The Council believes that the potential conflict of interest between a Firm advising a client as an agent whilst holding a position in that security can be adequately resolved by requiring the Firm which is executing agency orders to observe the principles of agency or, when dealing as principal, to disclose its capacity at the outset.
- The potential conflict of interest between discretionary portfolio management and principal trading is, however, another matter. Although the Council has no doubt that broker fund managers at present deal at arms-length as agents, there is a strong view that discretionary fund management should be seen to be entirely independent of any principal dealing function in future. Any Broker Dealer who wished to be able to take as a principal would need to run its discretionary fund management separately so that it was free to deal with any broker. It would be able to deal direct with its related broker acting as principal or market-maker only if it could do so at the best available price. The reporting of transactions to the client would then include a disclosure that the fund manager had dealt with a related principal. Where discretionary clients preferred their funds to be managed by a named Member within the Firm and not from a separate organisation the client should however be able to opt for this treatment by a signed authority to the Member, which should authorise him to deal with a related marketmaker provided the nature of the transaction was fully disclosed.

70. A further potential conflict arises for the broker to a company who may wish, or may find it necessary, to be a market-maker in the company's securities. Such Firms already need an effective Chinese Wall between their corporate finance and their broking activities. It is for further discussion how this potential conflict of interest can be resolved.

#### THE GILT-EDGED MARKET

- 71. The present jobbing system for UK gilt-edged securities has worked successfully for many years in both the primary and secondary markets. But the Authorities and the Council are conscious that the market's long term viability in its present form is not assured. Experienced and well capitalised financial houses have said that they would like to deal direct with the Bank of England and make markets in gilt-edged stocks. The Bank has made it clear that in principle it does not feel it can ignore these applications. In these circumstances, the Council concludes that it is not feasible to continue the single capacity market system in the gilt-edged market, especially if single capacity is not maintained in other parts of the market.
- 72. It is to be expected that the Bank of England will continue to operate in both the primary and secondary market in Government Securities. It will wish to influence the identity and control the capital and market-making requirements of the market-makers with which the Bank itself deals, and will be concerned with the prudential regulation of those Firms.

- 73. The Council wishes to define a system which will be compatible with the system for equities and enable the gilt-edged market to continue to operate within The Stock Exchange. In the Council's view, a new market system for gilt-edged securities should be developed on the lines of the market for Treasury Bonds in the U.S.A., and should be introduced at the time that fixed commission scales for gilt-edged securities are dismantled. It would be the aim to achieve the most competitive and liquid market possible, and outside houses with the necessary dealing skills and capital backing would be allowed admission to the market in due course. The Stock Exchange would regulate the market within its membership structure and its administrative compass, and run the information and settlement systems supporting it.
- 74. A number of Broker Dealer Firms would be recognised by the Bank of England as primary dealers. Primary dealers would make markets and deal directly with investors as well as with Broker Dealers as agents for investors. Other Broker Dealers would not be so recognised but would be able to attract business either as agents or as fair-weather principals or in a regulated combination of roles. The primary dealers would have market-making obligations, as required by the Bank of England, and would be obliged to make continuous markets in acceptable size in a full range of securities, perhaps being allowed to specialise in the short or longer end of the market. Primary dealers would be subject to strict capital requirements. The Bank may require

their gilt-edged market trading activities to be conducted through separately capitalised UK registered subsidiary companies. Primary dealerships will not be limited to Firms with large capital, making prices in large size and taking large positions. The criteria will be scaled in accordance with the size of business which the Firm intends to do. A Firm proposing to make prices in smaller size with a relatively low position limit would have a correspondingly smaller capitalisation requirement. There would also be other criteria for recognition covering, for example, the number of personnel, their experience and qualifications. Financial and market-making supervision, conducted both by The Stock Exchange and the Bank of England, would be strict and regular.

- 75. In exchange for submitting to these obligations it is to be assumed that the Bank of England would grant primary dealers access to tap stocks, and extend to them the privileges enjoyed by the gilt-edged jobbers in the present system.
- 76. It is implicit that the basic building block would again be the Broker Dealer. Some professional investors would tend to deal direct with the primary dealers, who would be making net prices as principals: others would be likely to deal through their agent Broker Dealers.
- 77. If the US pattern of activity developed it could be expected that a significant proportion of dealing in the big market would be

between the primary dealers themselves, undoing trades with customers, hedging parts of their book against other parts, selling short in one security or maturity to go long in another, and adjusting their books to be able to take issues. Substantial hedging in futures and options markets would become common practice. It is possible that smaller Firms of gilt-edged jobbers will wish to be recognised as primary dealers and provide a subsidiary market-making facility in smaller amounts. Thus a connection would be established between the small and the 'wholesale' markets.

- 78. It should be noted that the Treasury Bond market in New York is characterised by intense competition among the thirty-eight primary dealers. Because their prices to customers are very narrow the dealers do a very large amount of business among themselves in order to re-distribute their risk positions. In order that this inter-dealer business can be done anonymously, a small number of inter-dealer brokers have emerged. These brokers have no other securities business and are entirely engaged in matching business between the primary dealers using information screens. There is a closed-circuit system between the primary dealers but they also disseminate their own indicative prices to the public through commercial information vendors whilst indicative prices appear in newspapers. But these do not of course give reliable dealing prices.
- 79. As to information systems in the future gilt-edged market system, it is conceivable that an electronic means of communicating

anonymous bids and offers between dealers could be developed and even that specialised inter-dealer brokers would emerge. In any event, it is likely that there will be a need for an electronic display system through which market-makers can publish their quotations, or other Broker Dealers their indicative prices, to participants in the market and to investors. The Stock Exchange would wish to be responsible for such information services.

- 80. It would be mandatory that all settlement of gilt-edged transactions in the 'primary dealer' market should take place through the book entry transfer system run by the Central Gilts Office. The entry of bargains to the settlement system will continue to be by way of the central checking system and, as for UK equities and company fixed interest securities, the principal means of investor protection will be the examination of these records and the re-constitution of dealings. It is not intended that there should be a last trade reporting and publication requirement in the gilt-edged market.
- 81. In the U.S.A. the market is largely professional only about five percent of dealings are by private investors and professional investors are said to be adequately protected by the sheer intensity of competition between dealer practitioners whereas, in the UK, private investor interest in the gilt-edged market is much greater. It is desirable that private client business should continue to be dealt through an agent broker network operating under a best advantage rule. This is one

reason why the market should operate within The Stock Exchange. It is for further discussion whether small business and any business matched by a Broker Dealer upstairs should be directed or exposed to a primary dealer.

Market arrangements of the kind described predicate a number of highly capitalised primary dealer Firms capturing a large proportion of the existing institutional market in gilt-edged securities and dealing with orders on a principal-to-principal basis. A number of the primary dealers would be formed by existing Member Firms; others would be subsidiaries of organisations not at present within The Stock Exchange. The implications of the latter factor are discussed in the section of this paper dealing with new entrants.

# TECHNICAL IMPLICATIONS

83. Clearly the suggested new methods of trading for equities and gilt-edged securities will entail some changes to The Stock Exchange's market information, and settlement systems, and the development of important new systems for both trading support and settlement. These developments will require considerable expenditure.

### Information Systems

84. As far as information systems for competitive market-makers are

concerned, some form of computerised facilities will be needed for the following distinct functions:-

- 84.1 Collection of up-to-the-minute firm bid and offer quotations with size from market-makers in equities, and perhaps from the primary dealers in gilts, both on the trading floors and in their dealing rooms; possibly also the collection of firm limit orders.
- 84.2 The dissemination of up-to-date comparative quotations to the offices of Member Firms and to the floors. As this information system might be the equivalent of the floor in a new system, it should be equally accessible to the dealers for all Member Firms although not necessarily to every office in the country as some Firms will no doubt use dealing agents. Whether or not the communication costs should be 'mutualised' i.e. equal to all Members, is for further consideration.
- 84.3 The collection of last trade information in UK equity and company fixed interest securities from all Member Firms wherever a trade is executed, whether on one of the floors or in a dealing room or office. These reports would comprise firm, stock, size, price and time of execution. If last trade information is eventually subject to immediate publication there would be a limit to the delay that could be accepted between execution and reporting.

These trade details would be retained centrally for the purposes of market surveillance and trading reconstruction.

- Services) en route for other market information services, of a middle market price based on the current 'touch' in the market, as derived from the market-makers' and primary dealers' current quotations; in other words from the best bid and the best offer quoted, not necessarily by the same Firm.
- 84.5 At a later stage, perhaps, distribution via TOPIC and CRS of last trade information limited to stock, price and size.
- 84.6 Facilities for market surveillance, to monitor price and quotation continuity in real time.
- 84.7 Facilities for later reconstruction of events in the market from the record of quotes and trades, as an aid to the conduct of investigations.
- 85. If a specialist system is adopted for the leading securities many similar facilities will be necessary. The collection of last trade information will be simplified by collection at the specialists' trading posts. Their immediate publication may be necessary.

- 86. The satisfactory operation of the new market will depend increasingly on its systems support. These systems will need to be highly reliable yet capable of rapid adaptation as the market, its membership, its rules, practices and patterns of activity evolve and are adjusted following the major structural changes which are in prospect. Furthermore, these systems will have to be provided in a short timescale relative to other major system developments in the securities industry. The most reliable systems are invariably those which have been running for a number of years and have bedded down. Computer systems can never be as infinitely flexible as systems which use people.
- 87. A two stage approach to system implementation may be necessary. In the first stage, adaptations might be made to the existing TOPIC system to handle the entry and distribution of quotes. Quote changes would be notified centrally through a telecommunication system. This scheme mirrors quite closely the facilities provided for the Traded Options Market which was put in place very quickly but is on a much smaller scale. In this first stage a measure of necessary experimentation and adaptation would be feasible. The nature and pattern of business which continues to be done on the trading floors will begin to clarify and Firms will become accustomed to working with the new dealing methods. They will also need this time to plan and implement changes to their own systems and telephone arrangements.
- 88. This approach has not yet been planned in detail; nevertheless, it is hoped that a basic short-term system could be available by

late 1985. It will be necessary in the second stage to develop a high-performance system to handle quotes and trades but this is a major development which could take considerably longer. This system would provide facilities for Firms to update their own quotations and to enter their last trades at their terminals.

- 89. Additionally, it can be expected that, as knowledge of working the new market increases, there will be demands for additional systems, perhaps including the potential to handle real time checking of bargains for settlement, to link into Firms' own computers for order handling and possibly a measure of automatic execution under the Firm's control. This is a rapidly increasing trend on all the principal exchanges in the USA, in Toronto and in Tokyo. Such facilities may become necessary for the increasingly international and competitive market ahead and the Council will plan accordingly.
- 90. The Council is looking carefully at information and dealing systems in use in other markets and may be able to adapt one of these to suit the U.K. market. It must not, however, be assumed that it would be feasible to acquire one of these systems outright and install it on a short timescale with a large number of terminals.

### Settlement Systems

91. Since its introduction in 1979 Talisman has proved an effective, efficient and reliable central settlement system. The Council

believe that it is imperative that all business generated by any new dealing system for UK equities and company fixed interest securities should be capable of settlement through Talisman or its successor. Intensive technical research is underway in order to determine the extent to which Talisman can be modified in order to incorporate the ideas in this paper.

- 92. Separate proposals are being put together for a major overhaul of Talisman, which is becoming difficult to enhance for the many additional services which are being demanded. These proposals will draw on more modern technology and techniques and will provide its participants with a wider and more flexible service. But this new settlement system will take some years to complete and cannot therefore be used to settle business in the new dealing environment from the outset.
- 93. For the first years of the new dealing system the current

  Talisman arrangements, with certain adaptations, will be used.

  This will contain some limitations which will affect the dealing structure.
- 94. The primary limitation within Talisman is the number of market-making participants able to have full trading account facilities in any one security. The largest number is in practice fifteen. In other words, if the competitive market-making system is adopted there will be an upper limit of fifteen market-makers

able to register in any one security. This may well be adequate but, if more market-makers wish to register, preference may need to be given to those undertaking to market-make in the largest number of securities.

- 95. The only new addition to the Talisman system would be a means by which a Broker Dealer could accept stock from one or more selling clients and have this stock delivered through the system to one or more of its buying clients. The production of such a facility is expected to utilise some of the arrangements contained within the stock account system, which is being developed for the Australian settlement system. Broker Dealers not registered as market-makers, but acting as principals in a particular security, would have facilities made available to them through this stock account system. The facilities would however be more limited than those available to the market-makers and Accredited Dealers.
- 96. For a specialist system there would be a major problem of brokerto-broker settlement and, at least to start with, it may be
  necessary for all deals to be booked through the specialist or
  perhaps through a Stock Exchange nominee with a 'trading account'
  to avoid major changes to the Talisman system.
- 97. The changes to be made for the start of the new dealing system will be very much in the nature of a short term expedient. A new and more powerful settlement system based on Talisman is

essential if the maximum benefits of central settlement are to be made available to Members under a new market system. Whether or not even these short-term changes to Talisman can be made by late 1985 is still under review. At the same time, resources will have to be made available for the completion of the Central Gilts Office book entry transfer system for gilt-edged securities.

98. In any developments which The Stock Exchange undertakes it will ensure the fullest consultation with Member Firms so that compatibility with their own internal developments is given utmost priority.

#### MEMBERSHIP

99. New dealing systems will give rise to the need for increased capital in Member Firms, whilst the desirability of maintaining the central market will also lead to the greater involvement of outside houses. Accordingly the Council has conducted a review of the present membership system. The Stock Exchange imposes a substantial body of rules governing the conduct of Member Firms. An outline of some of its main features is given first.

### Main Features of the Present System

100. Admission to membership is granted by the Council; a candidate must have completed three years training with a Member Firm, have passed The Stock Exchange Practice examination, be proposed and seconded by existing Members (who must satisfy the Council that the candidate is a 'fit and proper person'), and must secure a 75% vote of the Council in his favour. Members may not have business interests outside their Firm without the consent of the Council. Member Firms are constituted on the basis of unlimited liability - on the part of the Member principals in the case of partnerships and unlimited corporations, and on the part of Member directors (and some other Members) in the case of a limited corporation. All principals in Member Firms must be Members. Only Members may trade with other Members using the facilities of the trading floor. Only Members may nominate and vote for Members of the Council. Only Members may be Proprietors of The Stock Exchange.

- 101. Membership also entails obligations. A Member once elected is liable for the amount of entrance fees, subscriptions and other payments and charges fixed from time to time by the Council. A candidate for membership has on election to pay the sum of £1,000 to the Trustees of the Nomination Redemption Fund, which sum is not returnable. A Member, as a Proprietor of The Stock Exchange, has unlimited liability for its debts and obligations.
- 102. To become a principal in a broking Firm a Member must either pass a further three examination subjects or he may become a principal after passing the Technique of Investment paper and having served as an Associated Member for seven years, at the conclusion of which time the additional experience he has gained is deemed to be of equivalent value to his satisfying the examiners. A jobbing Associated Member, having passed the Stock Exchange Practice paper, is not necessarily required to pass additional examination papers but he must serve a further three years before he may become a principal. The present membership is divided into roughly equal proportions of principals and Associated Members. In London there are approximately 1,600 principals and 1,600 associates; in the provinces there are approximately 700 principals and 300 associates. It will be appreciated that nearly half of the Members of The Stock Exchange do not therefore bear unlimited liability for the debts and obligations of the Firms with which they are associated.
- 103. It should be appreciated furthermore that the rules now permit à situation where Member principals in a Limited Corporate Member

are not required to own any shares in that corporate Member. (In such circumstances they are required each to have outstanding a subordinated loan to the company to the value of at least £10,000). The ownership of a Limited Corporate Member may be completely divorced from its directorate.

- 104. The principle of 100% outside ownership of Stock Exchange Firms was conceded as long ago as 1969 when Limited Corporate Members were first admitted. The rules as then drafted ensured that no single party could acquire more than 10% of a Limited Corporate Member, but they also made it possible for the ownership and the management of Limited Corporate Members to be separated and for 100% of the shares of the company to be owned by non-members. Subsequent changes to the rules have not interfered with the general principle but have sought to ensure that Members retain adequate control over the Firms in which they operate whilst permitting an increase in the level of ownership which can be allowed to any one non-member. Currently, the maximum permitted level of ownership by a single non-member is 29.9%.
- 105. Financial regulation is now almost entirely concentrated on Firms and little account is taken of the financial standing of individual Members. The recent change in the calculation of the minimum liquidity margin (from one depending on a count of Members to one involving an expenses ratio) has emphasised the importance of the Firms, and the relative unimportance of personal membership, in financial regulation. But personal

membership is of the utmost importance in other regulatory areas.

- 106. Restrictions on entry are necessary for The Stock Exchange to enforce its regulatory authority and to ensure a high standard of conduct and discipline among its Members. The purpose of the membership rules is to ensure that as far as possible Members are competent, honest, and fully committed to their Firms and to The Stock Exchange.
- 107. The general effect of these restrictions has been to ensure that non-members can have only very limited and circumscribed interests in Stock Exchange businesses. Where permitted, such interests can be no more than financial and may not involve any degree of control. Member Firms are thus always controlled by individual Members of The Stock Exchange, who are of course themselves directly subject to The Stock Exchange's authority. Reinforcing The Stock Exchange's authority over individual Members are the unlimited liability rules; further limitations on non-member involvement are to be found in the rules governing the outside activities of Members and Member Firms. A Member must obtain the consent of the Council if he proposes to have any business interest in a financial field outside The Stock Exchange, or to accept unlimited liability in any business activity outside The Stock Exchange. These rules are based on the general principle of individual membership and of unlimited liability, which has been regarded by The Stock Exchange as an

essential feature of its regulation of the market. In practice however they have served also to ensure that Stock Exchange business is conducted by relatively small and independent Firms, and to exclude the involvement of outside financial and other corporations, other than as investors.

### The Scope for Change

- 108. The rules should strengthen the membership of The Stock Exchange so that it can compete effectively with other major securities markets and security dealers. The Council is accordingly considering a number of alterations to the membership structure which are summarised below. In almost all cases these alterations would represent a radical change. They aim to satisfy the objectives set out in paragraphs 2-8 of this paper.
  - 108.1 There should be two classes of individual Member.

    'Principal Members' would include all executive Member directors of present corporate Member Firms and all partners in Stock Exchange partnerships. Those who would be held accountable for the conduct of their Firms would normally have to be Principal Members. The other class would be entitled 'Representative Members'. These Members would include all those who gave advice to the public on behalf of their Firm and were authorised to commit the Firm in market dealings. Suitable examinations would be imposed, but exemptions would be

available for individuals with relevant practical experience.

The Council envisage a development in which some Member Firms would act as 'clearing members' for other Firms. There has been a significant trend in the USA towards severing dealing and settlement from the advising of clients and the taking of their orders. In this environment firms known as 'introducing firms' appoint clearing firms to do their settlement, and sometimes their dealing. Introducing firms can be modestly capitalised and can concentrate on business getting and servicing their clients, perhaps as discount brokers, leaving the dealing and settlement to other better capitalised and perhaps more specialised Firms. If clearing membership became established, consideration could be given to admitting sole traders to the market, who would help to create the two-way view on securities which is often missing now. The success of many of the new exchanges in the USA is based on the liquidity they have been able to attract by permitting sole traders to operate in conjunction with clearing corporations. In addition, the introduction of clearing membership could possibly assist the viability and future development of smaller Firms wishing to specialise in investment advisory services to individual investors.

- appoint non-members to be non-executive directors of
  Limited Corporate Members, provided always that the
  number of Member executive directors, subject to the
  authority of the Council, exceeds the total of nonmember directors and subject to a power of veto in
  certain circumstances in the hands of the Stock Exchange
  Member directors, to ensure that regulatory control by
  The Stock Exchange was adequate.
- The present barrier against single non-members owning more than 29.9% of a Member Firm would be further relaxed. A change to enable up to 100% to be owned by a single non-member would take place at the time the dealing system changed and commissions became negotiable; at the same time outside owners would be permitted to set up new Firms. The Council would retain the right to disallow the sale of Member Firms to, or the establishment of new Firms by, outside owners which it deemed unsuitable. Meanwhile, a Member Firm would be permitted to grant options to, or make contractual arrangements with, a substantial holder over capital in the Firm in excess of the currently permitted 29.9% holding.
- 108.5 In addition, existing broking and jobbing Firms would be permitted forthwith to contract to form consortium

Broker Dealer Firms although such Firms would not be permitted to commence operations in their joint form before the dealing and commission systems changed.

- 108.6 The stipulation that a non-member must not own an interest greater than 5% in a Member Firm when it already owns 29.9% of another Member Firm would also be relaxed. An outside shareholder who owned 29.9% of the capital of one Firm would be permitted immediately to acquire further holdings up to 29.9% of Firms operating in the same capacity, i.e. in two or more broking Firms or in two or more jobbing Firms. The current level of restriction to 5% for investments where the capacities of the Firms are different would remain for the time being whilst the market remains on a single capacity basis. Options can be granted or contractual arrangements made during this period. The requirement for a substantial non-member shareholder not to contribute more than 20% of a Firm's revenue would also remain for the time being but would be re-assessed once the future shape of membership had been agreed.
- 108.7 Directors of, and certain other Members with, Limited
  Corporate Members who, under the current rules of The
  Stock Exchange, have unlimited liability for the debts
  and obligations of those corporate Members, will be
  permitted limited liability from the date of the change

permitting individual non-member shareholdings in excess of 50%. The Council note that the Government currently propose in the White Paper 'A Revised Framework for Insolvency Law' that directors of limited liability companies should lose the protection of limited liability if they engage in wrongful trading. The trend towards limitation of liability cannot however go much further; shareholders in unlimited liability companies and general partners in partnerships have, under the law of the land, unlimited liability for the debts and obligations of such Firms.

108.8 The conditions for the establishment of new Firms would be the same as those applying to existing Firms, namely that a majority of the Board must be duly elected Principal Members of The Stock Exchange. The number of Representative Members should be at a level to support the scale of the new entrant's business, and its Stock Exchange activities should be contained, where required, within a separately constituted and capitalised entity. It would be a requirement that the Firm undertook to conduct its business in the UK under the rules of The Stock Exchange, using the central settlement systems. Member Firms would not in general be permitted to have subsidiaries conducting activities regulated by non-Stock Exchange bodies because of the problems posed by conflicting regulatory requirements. Such activities

would be conducted through 'sister' companies under a holding company.

- The Council would establish a proper cost for would-be new entrant Firms to The Stock Exchange. It should be set at a level which is not so expensive as to deter entrants nor so cheap as to damage the position of existing Member Firms. The Council is considering the creation of a system of Stock Exchange seats, which entrants must acquire initially from existing Member Firms, in order to conduct their business in The Stock Exchange. This innovation is referred to more fully in paragraphs 119 to 125.
- 108.10 The Council are also considering whether a new Firm should be liable to pay an entrance fee on admission to The Stock Exchange and whether the purchase of seats from other seatholders should entail some payment to central reserves. As with the requirement to acquire and hold an appropriate number of Stock Exchange seats, the payment of an entrance fee would substantiate its membership of the central market in the UK, and its access to valuable services which have been built up by the present Members. The proceeds of these latter payments would be taken to central reserves, and would lighten the burden for Members in that they would help to fund future technical developments and reinforce the financial backing for the Compensation Fund.

108.11 Consideration will be given to determining how new entrant Firms may enter The Stock Exchange, other than by acquiring the equity of an existing Member Firm and by developing its business in a 'normal' way, and whether 'new entrants' should be defined to include those existing Firms whose business has been transformed out of recognition by an outside owner over a brief period, or new Firms put together by existing individual Members, but effectively controlled by external interests.

### Regulatory Implications of Change

- 109. The possibility of a Member Firm being owned or controlled by a single non-member (i.e. by its owning in excess of 50% of the equity capital of the Firm) raises complex regulatory issues. Traditionally, Stock Exchange regulation has largely depended upon its control over individual Members, and even though The Stock Exchange continues to insist that all executive directors of Limited Corporate Members should be Members, a controlling shareholder could still exercise a dominant, and possibly harmful, influence unless there were a countervailing power in the hands of Members.
- 110. Some might argue that The Stock Exchange could only be confident of the standing of a controlled Member Firm if it could also fully regulate the non-member parent. It might be claimed that, if the Member Firm were a subsidiary of a large group, The Stock

Exchange could have no assurance that the liquidity margins reported in the regular financial returns were genuine and had not been created by group accounting. As The Stock Exchange would not be able to regulate the parent of such a Member Firm it would have to be in a position to exercise some control over the parent's relationship with the Member Firm, to ensure that the Firm remained a free standing entity; that the activities of the group did not disguise the position of the Firm; and that group management did not lead the Member Firm to break Stock Exchange rules. The Stock Exchange would seek the assistance of other authorities to bring non-member parents within the regulatory ambit of The Stock Exchange on the lines of the 'approved person' rules of the New York Stock Exchange. These rules permit Stock Exchange regulators to 'look through' a Member Firm subsidiary to its parent corporation to require it to provide information needed for the regulation of the subsidiary.

- 111. Although the importance of personal membership from the standpoint of the effective transaction of business or of financial regulation has to some extent declined, it remains of paramount importance in disciplinary matters and for the general regulation of the conduct of business on The Stock Exchange. Far from accepting the view that personal membership is outmoded the Council believes that it will be the key to the effective regulation of Stock Exchange Firms once 100% outside ownership by a single non-member is permitted.
- 112. In admitting new organisations to membership The Stock Exchange

might wish to insist, as it does now, that all of the principals of a Member Firm should be Members subject to discipline. However the Council permits Limited Corporate Members to appoint to their boards non-executive directors so long as they remain in a minority to the Member directors. Given the very uncertainty in the law of the concept of a non-executive director, the Council has considered whether it is right to confine the representatives of a controlling shareholder, which had acquired a Member Firm, to a non-executive role. Their provisional conclusion is that, with the proviso in the following paragraph, this would be right since it is difficult to see how in practical terms such directors could be expected to pass The Stock Exchange examinations, and to serve an apprenticeship before they could be proposed for membership and become executive directors.

113. Nevertheless the Council believes that there should be provision for certain representatives of outside shareholders to be permitted to become executive directors. Those outsiders whose experience was of relevance to The Stock Exchange and who were prepared to accept the obligations of membership and the discipline of the rules should be enabled to become Members - Principal Members not merely Representative Members - by application to the Council which would grant waivers, where it was thought appropriate, of the examination and training requirements. The number of Members granted a waiver should be few in each Firm; the public interest demands appropriately trained and examined Member Principals. It would continue to be the case that non-members could be appointed non-executive

directors and would not be required to serve any training period or pass any examination papers.

- 114. At the same time the Council believes that the status of a Member should be broadly commensurate with the power to commit a Member Firm. All those who are able to commit a Member Firm in its Stock Exchange business, whether in dealing or by accepting orders from the public, and most importantly all those who give advice on behalf of a Firm to the public, should be Members. All such people and all current Associated Members and, probably, all authorised clerks would be styled Representative Members. Current principals in Member Firms, that is partners and directors, would be Principal Members. With all executive staff brought within the regulatory control of the Council, the issue of the ownership of Member Firms becomes of less significance from the regulatory standpoint. It will be possible for a Limited Corporate Member to be 100% owned by a non-member if the actions of that Corporate Member itself and of all personnel are adequately controlled as Members by the Council.
- 115. In the USA, with only very limited exceptions, no person can engage in business as a broker dealer in securities without complying with the registration requirements of Section 15(a) of the Securities Exchange Act 1934. The Act defines a broker as 'any person engaged in the business of effecting transactions in securities for the account of others'. A dealer is 'any person engaged in the business of buying and selling securities for his

own account'. The definition is sufficiently wide to embrace all salesmen who advise and solicit orders from the public. All registered broker dealers, regardless of their affiliation with a self-regulatory organisation (i.e. a Stock Exchange), must meet the Securities and Exchange Commission's standards with respect to training, experience and competence.

- 116. The New York Stock Exchange, however, as a leading self regulatory authority extends its regulation further. It will not permit its firms to allow any SEC registered person to perform regularly the duties customarily performed by a registered representative, unless such person has been registered with and is acceptable to the Exchange. The term 'registered representative' is defined as 'an employee engaged in the solicitation of orders and for the purchase and sale of securities or other similar instruments for the accounts of customers of his employer or in the solicitation of subscriptions to investment advisory or management services furnished on a fee basis by his employer'.
- 117. A similar definition would be adopted by The Stock Exchange and it would mean that such employees would have to be Representative Members. Employees would be eligible for admission as Representative Members after one year of employment with a Member Firm but would be permitted to advise clients before that period had been served, if they operated under the direct supervision of a Principal Member or a Representative Member. Representative Members, like Associated Members today, would be required to pass

or be exempted from the appropriate Stock Exchange examination standard. Those who failed to pass after several attempts would be excluded from Representative Membership and would not be able to advise clients. A date would be set in the reasonably near future by which time all Representative Members would have been required to pass The Stock Exchange Representative Members' examination. Exemption from this examination would be permitted to present Associated Members and to those with appropriate experience with their Firms.

In summary, provided Stock Exchange Firms are under the 118. management and control of Members, considerably increased nonmember involvement in Member Firms could be permissible. With this approach, the main features of the present regulatory system would, to a greater or lesser extent, be preserved. The Stock Exchange would continue to have authority to admit - or to refuse to admit - individuals as Members of The Stock Exchange. It would require that only those admitted individuals would have authority to commit a Firm in Stock Exchange business. Thus while non-member shareholders might put pressure on a subsidiary Member Firm to break The Stock Exchange rules, the individual Members, by yielding to such pressure, would leave themselves open to disciplinary action by The Stock Exchange, and in the extreme case of all of the individual Members being suspended. the Firm itself would in effect be prevented from continuing to conduct a Stock Exchange business. The Stock Exchange would regulate the Firm as well as the individuals concerned. A nonmember controlled Member Firm would be regulated both as regards its own dealings and with respect to its relationship with its parent. While The Stock Exchange could not expect to regulate the parent itself, it would be in a position to assure itself of the standing of the Stock Exchange entity and to impose its discipline on it.

### A Seat System

- The Council have also considered arguments advanced in the context of wider entry to membership, that such incoming Members would immediately become part 'owners' of all The Stock Exchange assets. It is argued that, for what may be a relatively modest payment to the owners of a current Stock Exchange Firm or to The Stock Exchange itself, an entrant gains rights over a valuable freehold property, as well as over valuable settlement and communication facilities and over cash reserves. In fact such rights are realisable only if the Members, as Proprietors, were to pass a special resolution at an Extraordinary General Meeting to make the necessary amendments to the Deed of Settlement and to dissolve the Undertaking, which, it should be recognized, would be open to challenge in the Courts.
- 120. A new Member may not acquire realisable claims over the assets of
  The Stock Exchange but he does acquire a share in an organisation
  which occupies the central and dominant position in the trading
  of securities in the United Kingdom and Ireland, which has built

up two centuries of goodwill and which is a 'recognised' Stock Exchange whose Members are thus freed from the necessity of compliance with the licensing requirements of the Prevention of Fraud (Investments) Act. He also becomes a beneficiary of an extensive communications network and of a well developed information technology capability. The current system of personal membership could permit new Firms to enter in a way which did not reflect the advantages of membership.

- 121. On the other hand admitting major securities houses will make London a better and more liquid market. London has unrivalled time zone and regulatory advantages, but in a 24 hour market it is competing with other Exchanges for order flow. It will not partake sufficiently in that order flow unless it brings the outsiders into the system, primarily through their acquisition of interests in existing Member Firms, but, also, if circumstances demand it, by allowing entry to new Stock Exchange Firms. In considering this The Stock Exchange must have regard to the membership admission policies of other Stock Exchanges. It would seem fair to permit entry to firms of those Exchanges which permit entry to Firms of this Exchange, i.e. to institute a reciprocal membership policy. The entry of firms from Exchanges which prevent or discourage membership by Stock Exchange Member Firms or their subsidiaries needs further consideration.
- 122. While outside entrants to the market should be encouraged they
  must expect to pay some consideration for the benefit they gain

by joining. The Council is considering the creation of a system of Stock Exchange seats, which is referred to again below, and an entrance fee payable to The Stock Exchange.

- 123. A seat system is a common method of providing membership of an Exchange market place, whether for securities or commodities dealings, in many centres around the world. Indeed, until 1970, the London Stock Exchange maintained a kind of seat system in its arrangement of individual Nominations, and that system is being reconsidered.
- There are numerous ways of bringing a seat system into being. A 124. simple arrangement would be to allocate seats to existing Member Firms on an equitable formula, perhaps relating to past contributions to the General Service Charge or tariffs, and to regard those seats as denoting rights of access to the markets and services of The Stock Exchange. The seats would not be backed by the assets of The Stock Exchange - they would be analogous to licences, but would be transferable amongst Member Firms of The Stock Exchange (including the new entrants) at prices reflecting the balance of supply and demand. New entrant firms would be required to acquire and hold a number of seats appropriate to some measure of the scale of their business, as would existing Member Firms which wished to expand their operations. The Council would retain a reserve power to issue new seats at an appropriate price and time. Under this scheme the ultimate rights to the assets of The Stock Exchange in a

dissolution would remain, as now, with individual Members of The Stock Exchange who would also retain ultimate liability for its debts. This version of a seat system would not involve major constitutional change.

125. A different approach to a seat system could involve the capitalisation of some of the assets of The Stock Exchange, particularly the assets represented by the technical services. The Council is seeking advice on the legal and taxation implications of a seat system, and of the capitalisation of assets.

#### The Compensation Fund

- 126. Some form of compensation must be available for investors and an important means of providing client protection over the past thirty years cannot be abandoned. The Council believes it is right that the Compensation Fund is constituted as a central responsibility of The Stock Exchange itself, but its operation and scope should be reviewed, given the likely changes in the market and membership structure.
- 127. It may be that it will be appropriate for the Council to limit the cover on individual claims at some stage in the future, on the lines of the Securities Investor Protection Corporation arrangements in the USA, or to restrict the backing of the Fund to the level of the current liquid assets of The Stock Exchange allowing for insurance arrangements, or to define further the classes of Stock Exchange business covered by the Fund.

#### CONCLUSION

- The Council is particularly concerned to set a realistic time-table for the implementation of whatever changes emerge from the discussion of this paper. Technical systems need to be carefully planned and tested. The co-ordination of The Stock Exchange's systems with Member Firms' systems and users' systems is as vital to the success of the new market as the formulation of new dealing practices and membership arrangements.
- 129. It is not exaggerating to describe the changes envisaged in this paper as a re-casting of the structure of The Stock Exchange. Therefore the timescale for implementation should be designed to respect the extent of the re-organisation involved which is considerably greater than that involved in the USA as a result of May Day 1975 and allow development to proceed expeditiously but with reasonable provision for contingencies.
- 130. The Council would be failing in its duty if it were to put at risk the smooth operation of the market by planning to introduce a new dealing system without first ensuring that its supporting technical systems had been satisfactorily established, and found to be robust in operation and acceptable to the practitioners in the market and to investors.
- 131. Respondents are asked to bear these considerations of timing in mind in their comments, which the Council would like to receive

by 31st May 1984. The length of this consultation period is not ideal but the principles of the new dealing system must be decided urgently so that technical developments can proceed. This dictates a short consultation period.

Prime Minere 4

KING'S HOUSE 26-27 KING STREET LONDON ECSY BOR EL 01-808 4033

PRIVATE AND CONFIDENTIAL

ALTER SALOMON

28th March 1984

tun hu. Italche,

The Annual General Meeting of my bank will take place on 11th April when, traditionally, I make a speech which deals as well with matters of general interest. I thought I would like to send you and I enclose herewith a copy of that particular part because I have taken the liberty of mentioning your name in it and because I think it is a matter in which you would probably be very interested.

The speech is embargoed until 12 noon on 11th April.

I do hope you are keeping well.

### THE GOWER REPORT - Caveat Emptor

Mr. Norman Tebbit, the Secretary of State for Trade and Industry, has presented to Parliament a Report by Professor L.C.B. Gower entitled Review of Investor Protection. The second part, including the draft of a proposed Parliamentary Bill giving effect to his recommendations, is to follow later.

In the foreword to the Report the Secretary of
State invited interested parties to comment on Professor
Gower's recommendations not later than 30th April, 1984, after
which the Government will decide and make known their intended
course of action.

### The Case against the Proposals

I have the highest regard for Mr. Tebbit but that does not include his Department. As far back as 1979 I suggested that it should be abolished. My first recommendation, therefore, is to repeat this.

I am now coming to the heart of the matter. To make changes in an established structure is always a good thing if they are constructive changes and improve matters, but if changes are made simply for their own sake, or for political or emotional "do-goodism", they should be strongly resisted, particularly if they involve an increase in bureaucracy, further interference with the market economy, and are executed by people whose knowledge in this particular field is limited to say the least.

I think I have a good record of warning in ample time of certain changes which had taken place or were about to take place and therefore what I have to say now takes into account this past track record.

There can be little doubt of the far-reaching effect of that appalling blunder "Competition and Credit Control" which has dominated so much thinking regarding the financial markets for a great number of years. The then Prime Minister, Mr. Edward Heath, and his Chancellor of the Exchequer, Lord Barber, with the approval of the Bank of England led us straight into the fringe banking crisis and the

hysterical over-reaction continues to this day. We had the Wilson Committee and the Banking Act 1979, which I strongly opposed in an address given to the Institute of Bankers on 1st April, 1980, in which I pointed out that it would prevent newcomers from starting out in business and would strangle the potential bankers of the Twenty-first Century at birth. It has and is leading to the amassing of banks in the hands of a very few to the detriment of the entreprenurial and imaginative ideas which young people could have. It should be noted that the Act has not prevented banks in this country giving totally irresponsible loans both nationally and internationally.

Now we are faced with the Gower Report, which has been drafted by a lawyer of very high standing and reputation but whose chastity has never been broken by any spell of practical experience. Most of those who would be affected by the Gower Report do not like it, but they are either having their arms twisted, or they belong to the circle of those who would be called "giver-inners - not stander-uppers". If one goes against this kind of imposition, i.e. government-inflicted interference in our daily lives one is called "an awkward chap". I am proud to know that in a recent speech

This was at the launch of his book of his

made by the Prime Minister she called me "the sergeant-major of the awkward squad" and added that we needed more of them.

In the Financial Times of 13th March, 1984, Mr.
Richard Lambert spelt out in a very succinct manner some of
his objections to the Gower Report and it is up to everyone to
get a copy of the Report and read it; it is very worthwhile.
Mr. Lambert began his article by noting that just about
everyone from Whitehall to Threadneedle Street seemed to have
approved Professor Gower's proposals but "is it possible that
they are completely, utterly, 100 per cent. mad?". I
personally think they are!

It is discouraging to note that the Bank of England is not raising its voice against this Report but then we have to realise that whilst in the old days the Bank of England was far more the banker's bank taking care of the interest of the banking community, it has today become an executive arm of the government, the Treasury and all that goes with it. So in this respect it is probably on a direct collision course with the financial community.

A few weeks ago, one of our leading newspapers in a somewhat tongue-in-cheek manner suggested the privatisation of the Bank of England. This should be carefully considered as it might help to solve the problem.

It is, of course, important that the investor should, within reasonable limits, be protected against disreputable fringe investment management consultants or consultancy firms, but this should not take away the responsibility of the individual investor to make his or her own necessary enquiries regarding known reputable firms. The known abuses in the securities industry, for instance, have so far been very limited and could easily be dealt with by the Prevention of Fraud (Investments) Act which could be brought up to date. The performance of those charged with implementing this Act has in the past not necessarily always been very encouraging because (1) they have taken far too long to look into cases reported to them and (2) once they have made a decision, e.g. that someone is not suitable to be a director of a public company they do not necessarily follow it through.

The present proposition may finally lead to something similar to the SEC (Securities & Exchange Commission) which they have in America. This is a haven for lawyers employed there and those advising clients whilst charging outrageous fees to get around the spirit of the regulations. At any

rate, to make changes at this particular moment seems to me to be very unwise as the traditional frontiers between different financial institutions are decreasing and will probably disappear within a reasonable time.

Whenever I hear of proposals for "self-regulating authorities" and suchlike I think of the opening remarks of the Prime Minister of Denmark at the World Bank Meeting in Copenhagen:

We shall have to evolve

Problem solvers galore 
Since each problem they solve

Creates ten problems more.

Professor Gower's propositions are from a practical point of view (1) unworkable, (2) interfere with the rights and freedom of the individual, (3) tremendously costly and (4) will build up a vast bureaucracy. The Prime Minister's philosophy has always been "let the market work and do not interfere". This is, of course, subject to the necessary safeguards for its the proper operation, but Professor Gower's Report is certainly not one of them. So my suggestion is: Caveat Emptor.

### Undeveloped Countries

My attention has been drawn recently to something which was written in 1953 by the great liberal economist, Professor Röpke. Professor Röpke, who died in 1966, was very much a forerunner of another great thinker and prophet, Professor Hayek, and it is regrettable that much of his work is now out of print. It would be a tremendous service if one of our leading publishers would re-issue these pioneering

In summary what Professor Ropke was saying so many years ago was that the same people who had pressed for the welfare state, the planned economy and collectivist inflationary policies which had been so disastrous for the West were those who were pressing for massive aid programmes to undeveloped countries. These aid programmes often take no account of the different cultural backgrounds of the countries concerned and presume that equalisation with the West is not only good for the countries concerned - in fact in many cases the attempt has proved disastrous - but also theirs by way of right.

It is still equally true today that many in the West feel that we owe the undeveloped countries something as a result of our colonial past. Of course, there are certain projects, particularly the development of infrastructure (harbours, roads, bridges, water mains, railroads, irrigation, etc.) that require a certain amount of government help, but in general terms the most dubious development plans are those that require planned economy compulsion and protectionist isolation.

Industrial development can be achieved only by basing industrial production on existing industries and types of

plant (which as a rule will be of the artisan and small industry type) and letting them grow according to specific local demand. The consequences of hasty over-industrialisation, which has been seen throughout the developing world, are economic disorganisation and in the Communist sector the realisation of the nationalistic ideal of dictatorship. The natural victim of the squeeze on the economy required to finance this over-hasty development is agriculture. The decay of an already poor country's agriculture can turn it into a truly stricken area.

The effective control of the birthrate is, of course, essential but equally important is the formation of a private capital market. As Professor Ropke points out, private financing has never totally dried up - it exists as credits by western exporters of machinery, advances from western purchasers, direct investments by daring international firms which, because of their size, can bear reasonable losses - however, once it was a stream, now unfortunately a trickle.

The reason why private capital cannot be attracted to such countries includes the extravagance of the economic plans concerned and the uncertainties of law, economic policy and currency in these countries. Specifically one is faced by unclear and fluctuating internal political relations; an alien

and unbalanced legal system; suspicion and hatred for everything "western"; expropriation; stubborn resistance to any reasonable demand by the western investor for guarantees, opportunities to inspect or to exert any influence on decisions regarding capital risks and employment of trained western personnel; collectivist inflationary policies and unpredictable local taxation and exchange restrictions. However, the greatest of all is the all-pervading corruption which is endemic in so many countries.

Marshall Plan type aid can only be justified in an extreme and temporary emergency; it cannot be demanded by way of right. It can only be used for building up the infrastructure of the country and should not be wasted on social experiments the way we did in this country. The demand by the countries concerned for what Ropke called "international forced capital formation" is part of the intellectual historical climate of "full employment"policies and derives from the ever-increasing weight of bureaucracy which effectively has the power to raise taxes. bureaucrats do not bother about the misera plebs contribuens, the ultimate bearer of the burden. The inescapable conclusion is that development programmes must be cut back to the size of the capital availale on the basis of an economic order based on market competition and the free price mechanism.

You might think the connection between the Gower Report and Professor Ropke is rather tenuous but in the one case there is a matter in which government wants to interfere but has not yet done so, whilst in the other there is a matter where government has interfered with disastrous results. A free society can only develop where there is a minimum of government interference. This has been proved over many years. So let us beware.

### Lombard

## Gower in the real world

INANCIM TIMES March 13 1984

> reform in the City of London. From Whitehall to Thread-needle Street, just about everyone has approved the pro-

> But is it possible that they are completely, utterly, 100 per

cent mad?

has had a wonderful press so far, but perhaps not always for far, but perhaps not always for the best of reasons. His heart is obviously in the right place, and he writes a great deal better than most journalists. What is more, he listens. He has taken great pains to adjust criticisms that were made of his preliminary report, and as a result there is almost nothing to offend anyone in the final version.

Maybe it would have been better if he had raised a few hackles. As it is, he has produced a review which looks completely rational on paper but which could just turn out to be a complete shambles in

Consider the key players in his scenario. There is the Department of Trade and Industry which, to put it Industry which, to put it politely, has not always been the most fast moving or astute of watchdogs in the financial of watchdogs in the financial sector. Its statutory duties will be considerably increased if Gower has his way. There is the Council for the Securities Industry which, to put it impolitely, has been more or less a dead loss in the first five years of its existence. There is the Bank of England, which has a creet knife into any organisation which challenges its authority in the City. And then there are a dozen or more self-

tory system as envisaged by Gower. Their executives will have the duty to supervise the behaviour of their members.

will really use such powers? trade associations, which will simply not put forward contro-

I'VE just had this terrible versial rulings that might upset thought. It's about the Gower their members. And it will be and yet small elongs to the that its members have something in common with each other. An example of this difficulty is the Accepting Houses Committee, which looks like a homogenous group of blue bloods, but which takes in a

Picture the scene. In a panelled office off Lombard Street, the flinty-eyed director of the clearing banks' self-regulatory agency stares unwaveringly at a group of half a dozen trembling executives, "National Midland," he barks "your behaviour recently has been appalling. You are to ha

Screams of terror as the picture fades.

My Terrible Thought is that the Gower proposals involve such a disparate group of reguagencies—one can imagine a merchant bank having to join four or five SRA's-that the whole thing will be unwork-

What are the weaknesses in the present system which this framework is meant to correct?
One is the disreputable management groups, which has largely resulted from the fact that the Prevention of Fraud (Investments) Act is decades potential conflicts of interest in different financial institutions

## Gower urges sweeping new powers to supervise City

for the Department of Trade and Industry were published yesterday in a controversial report commissioned by the Gov-

Ministers have already made clear their determination to in-

in 1981 following a series of scandals in securities firms which were not members of the London Stock Exchange,

### KEY RECOMMENDATIONS

Investment business illegal unless advisers and companies recognised by a Government agency or members of a recognised self-regulatory agency.

Number of self-regulatory agencies to be expanded, based on existing professional institutions.

The Council for the Securities Industry to act as

umbrella for other self-regulatory agencies and co-ordinate their activities. Department of Trade and Industry to maintain contact with the CSI

Tighter regulation of sale of life assurance. Statutory provisions for the public issues of securities, takeovers and insider-dealing transferred from the Companies Acts to new Investor Protection

1 Investor Protection Act to encompass the above recommendations.

Gower warns that "unless my and malpractice in the London commodities markets.

Prof Gower revealed yesters believe that they would be day in his report that over 50-fewer and that when they commodity firms were presently occurred less irremediable dam-

Professor Gower has recom-mended a mixture of statutory

investor protection. A new Investor Protection Act would

The Act would make it a criminal offence for firms to unless they are registered directly with the DTI or through membership of a self regulatory agency approved by

He said that the recognised self regulatory agencies would initially have to be based on existing professional associa-

for recognition, he said, were the Stock Exchange, the the Stock Exchange, the National Association of Security Dealers and Investment Managers, representing dealers who are not members of the Stock Exchange, a unit trust agency, the Association of Futures Brokers and Dealers, market and a certifying body for life

agencies should be represented on the Council for the Securities Industry which would maintain a role as the umbrella and co-ordinating body of self regulatory agencies and associa-There should be regular between council and the DTI, said Prof.

The Council for the Securities Industry, which has been attempting to establish itself as role might be diminished, said that Prof Gower had attempted to meet several points of con-

The council said it saw the publication of Prof Gower's report "as a significant step in the process of overhauling the Continued on Back Page

Details, Page 8; Gower's blue-print, Page 26; Editorial Com-ment, Page 26; Lex, Back Page.

### Gower

outdated legislation which now governs the securities industry."
Mr Norman Tebbit, Secretary for Trade and Industry, said that interested parties would have until April 30 to submit comments on Prof Gower's

Mr Tebbit said vesterday: "I remembering that his present report is already based on extensive consultation with

way forward." Sir Nicholas Goodison, chair-

### Continued from Page 1

given to powers be given to the Government to alter non-statutory rules. But he noted that Prof Gower now proposed that Government Orders for such

mentary approval.
"The Stock Exchange appears to conform in every respect to Prof Gower's model of a well organised self-regulatory agency," he said.

Mr Ian Hay Davison, chief executive of the Lloyd's insurance market, said he welcomed the Gower report. "If the Gov-He added that Prof Gower's ernment accepts the report's recommendation for formal recognition of self regulatory agencies, we shall seek it."

The National Association of

## Proposals for the regulatory system

THE Prevention of Fraud (Investments) Act would be repealed and replaced by an Investor Protection Act. Responsibility, for the administration of the new Act would be vested in the Department of Trade and Industry or in a self-standing commission answerable to the Secretary of State.

With certain exceptions, the Act would make it a criminal offence to carry on any type of investment business unless registered. The present distinction between licensed dealers of various types would disappear; all would be registered.

Registration would either be directly with the department, or commission, or through membership of a self-regulatory agency recognised by it.

The Act or regulations made under the legislation by the Secretary of State would lay down the hasic requirements which those registered would have to observe and would prohibit certain activities relating to investments whether or not carried on by registered persons,

The Act would empower the department, or commission, to make rules of conduct hinding on those registered directly with it and not through membership of a selfregulatory agency. Breaches of these rules, unlike the regulations, would not be criminal offences but could lead to cancellation or suspension of registration

A self-regulatory agency would not be recognised unless it satisfied certain conditions, including having rules which, having regard to the character of its membership, would ensure protection to investors at least equivalent to those of the department, or commission, and the ability to monitor their observance.

The recognised self-regulatory agencies would be responsible for ensuring the observance of the rules and regulations by their members and would, as an adjunct of recognition, enjoy certain powers and privileges.

Registration under the Act would obviate the need to be licensed under the Banking Act unless the firm accepted deposits otherwise than for the purpose of investment.

The Act would make provision for a harmonised system of regulation of public offerings, whether on an issue (primary or secondary) or a takeover and would contain a modernised version of the prospectus provisions presently in the Companies Act 1948.

# Dealing under school rules

THE FINAL draft of the Gower report on investor protection contains feet or protection contains feet or the first of the f

The Government in the person of Mr Norman Tebbit, has given it an initially rather given in the second of the seco

to be an easy one.

Before we come to the difficulties, it is worth rehearsing
the arcuments in favour of selfregulation. as opposed to
wholly official policing. They
lie in what might be called the
field of ethics rother than of
outright fraud—two topics
which are inclined to get
entangled in investor protection.

#### Ethos

Fraud can only be checked by clear rules, tight auditing and adequate punitive powers, and must always be a concern of the law. The more shadowy demands which must be met if high rather than minimal standards are to be met have always seemed to us better imposed by what amount to club rules.

Prof Gower draws attention to the public school ethos of the City, in which it is bad form to sneak; but this is the strongest argument in favour of self-regulation. Public school boys can'be quite ruthless in imposing their own code, provided the beaks are not called

However, this is not enough; the club rules must themselves be scrutinised, as recent experience in Lloyd's reminds us painfully.

which Prof Gower proposes, and on paper we would judge it to be the right one; but it is going to take a great deal of hard work to make it a reality.

work to make it a reality.

First, there must be a big effort on the part of the industry itself. Even its best regulated sectors, such as the Stock Exchange, fall a gond way short of the scope which will be received from the scope which will be section.

are no rules at all governing the fund management activities of stockbrokers. Other groups, and especially among the elite, have

Nor will they find it easy to meet what seem reasonable standards. The essential part of "ethical" investor protection, as Gower points out, is disclosure — of individual deals and of potential conflicts of interest — and disclosure is not a City

habit.
The Government also has a difficult job to do. Gower effectively offers a choice to those who handle investors' money—join a cubo or come under direct official supervision. The job, however, will be far beyond the capacity of any existing government agency unless cub membership becomes the zen-

This may involve a good deal of arm-twisting. For example, as the rules on dealing capacity and minimum commissions are removed, the costs and restrictions which have led to be growth of parallel securities markets in London—between overseas dealers and brokers or between accepting houses, for example—will also be removed. It will still not be easy to persuade these independents to foin their former rivals in a single example—will be independents to foin their former rivals in a single set.

Given the difficulties, there will he a strong tendency in the City to stonewall, and to arrue that practices which have served for more than a century are strill adonate: it is this presure which notificians, who tend to be averawed in face of the city, will find it hardest to resist. This will not do. The cold discolities were based on all senarations of function and interest which are breaking down as economies of scale, and the trend, to one-ston financial services, create new, copulo, prevates with built-in conflicts of

The Government must also steel their, are not its general members, to make available adequate resources to do the central into of scrutiny and supervision—which could well be paid for by the hardly powerly-stricked by industriel, the ion is done ball-heartedly, and sendals break out, the whole subtle and economical system which Prof Gower proses could be damaged beyond repair. This could be the last chance for public school rules.

Financial Time



### 10 DOWNING STREET

From the Private Secretary

18 January 1984

Dear Calum.

### GOWER REPORT ON INVESTOR PROTECTION

The Prime Minister has seen your letter to John Kerr of 13 January. She is content with the Press Notice which your Secretary of State will be issuing when the Gower Report is published.

I am sending copies of this letter to the other recipients of yours.

Your remarks

Andrew Turnbull

Callum McCarthy, Esq., Department of Trade and Industry.

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NBPM AT 1811

Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

17 January 1984

M C McCarthy Esq Private Secretary to the Secretary of State for Trade and Industry Department of Trade and Industry 1 Victoria Street LONDON SW1

Dew Callum ,

GOWER

with AT

Thank you for your letter of  $1\bar{3}$  January. The Chancellor is content with the Press Notice which your Secretary of State intends to issue when the Gower report is published on 18 January.

Copies of this letter go to the other recipients of yours.

Jun en, Jaken.



18 8 JAN 1984

Prime Himmin Agree to Tebbits reponse to (1) welcoming but DEPARTMENT OF TRADE AND INDUSTRY (ii) not committing HMG?

Inithant affach)

1-19 VICTORIA STREET LONDON SWIH OET

> Telephone (Direct dialling) 01-215) 5422 GTN 215) ..... (Switchboard) 215 7877

> > i3 January 1984

Secretary of State for Trade and Industry

J Kerr Eso HM Treasury Parliament Street London SW1

Dear John,

GOWER REPORT ON INVESTOR PROTECTION

The Chancellor and other colleagues mainly concerned agreed that the first part of the Gower Report on Investor Protection should be published as a Command Paper. I am accordingly now circulating proof copies together with the preface by my Secretary of State which will be incorporated, a summary compiled by Professor Gower himself and the draft Press Notice which we propose to put out at the time of publication.

17/1

- 2 My Secretary of State is sympathetic to the thrust of the Report but does not propose to commit himself to any further action until we have had the reactions of the interests concerned. His preface accordingly seeks comments by the end of April 1984. The Press Notice does, however, contain an indication of his sympathy for a regime based so far as possible on self regulation within a statutory framework.
- 3 Publication is planned for January 18.
- 4 Copies of this letter and attachments go to private secretaries of all Cabinet colleagues, and to Richard Hatfield.

Yours ever,

Private Secretary



PUBLICATION OF GOWER REPORT ON INVESTOR PROTECTION

A new and comprehensive statutory framework within which self regulation would be applied extensively in the securities industry is recommended to the Government in a report by Professor L C B Gower published today in a Command Paper (Cmnd ). The intention of the report's recommendations is to provide greater protection for both private and professional investors. This is the first and main part of Professor Gower's Report and gives his analysis and recommendations. Part 2, giving a draft for a Parliamentary Bill which he would propose in order to give effect to his recommendations, is to follow later.

- Professor Gower proposes a new Investor Protection Act which would provide for the overall regulation of investment business to be undertaken by Government or a Government agency, but with day-to-day supervision undertaken so far as possible by self regulatory bodies recognised for the purpose by Government. Professor Gower also recommends that the marketing of life insurance be made subject to a more extensive degree of regulation than at present; existing insurance supervision, essentially concerned with insurance companies' solvency, would remain unchanged.
- 3 The Secretary of State for Trade and Industry, Mr Norman Tebbit, MP, said today:

"I call on all concerned to consider Professor Gower's proposals in a constructive and positive spirit, remembering that his present report is already based on extensive consultation with interested parties.

The securities industry in its many ramifications is an important wealth creating sector of our economy. The experience of recent years has shown the need to review, and where necessary, strengthen, arrangements for protection of investors, but this should be done so far as possible in ways consistent

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with the liberal and innovative traditions of the City, which have fostered efficiency, enterprise, and competitiveness. Professor Gower's principle of self-regulation within a framework of statutory supervision may well be a way forward. Professor Gower is to be congratulated on providing us with a comprehensive survey, and a coherent set of proposals for consideration which reflect extensive research and discussion. To have done this, as he has, virtually single handed is a prodigious achievement, which deserves the thanks and admiration of all".

In a foreword to the Command Paper Mr Tebbit invites comments on Professor Gower's recommendations not later than 30 April 1984, after which the Government will decide and make known their intended course of action. Comments should be addressed to the Assistant Secretary (Gower Report), Department of Trade and Industry, Room 504, Sanctuary Buildings, 16-20 Great Smith Street, London SWIP 3DB. Copies of the Report are obtainable from H M Stationery Office, price f

### PREFACE

I present to Parliament herewith the first and main part of the Report by Professor L C B Gower entitled Review of Investor Protection. Part 2, giving a draft for a Parliamentary Bill which he would propose in order to give effect to his recommendations, is to follow later.

The proposals in the Report are Professor Gower's and Ministers will now be considering them. To help in this I invite interested parties to submit comments on Professor Gower's recommendations not later than 30 April 1984 after which the Government will decide and make known their intended course of action. I hope that all those concerned will consider Professor Gower's proposals in a constructive and positive spirit remembering that his present report is already based on extensive consultation with interested parties.

NORMAN TEBBIT

NOTE

Comments should be addressed to the Assistant Secretary (Gower Report), Department of Trade and Industry, Room 504, Sanctuary Buildings, 16-20 Great Smith Street, London SWIP 3DB

### REVIEW OF INVESTOR PROTECTION

### SUMMARY OF PART I OF PROFESSOR GOWER'S REPORT

Part I of Professor Gower's Report on his independent Review of Investor Protection in Relation to Dealings in Securities and Other Property is published today. It consists of his narrative Report and ninety-two Recommendations. Part II, containing a Draft Bill and notes on its clauses, is in preparation and will be published separately later in the year.

 $\frac{\text{Chapter 1}}{\text{and the philosophy on which the recommendations are based; namely, to provide the essential minimum of regulation needed to protect investors from being made fools cf, but not to attempt the impossible task of preventing them from making fools of themselves.$ 

Chapter 2 summarises the basic framework envisaged: see para 2.11. This follows the general lines of the Discussion Document published in January 1982, ie. regulation of those engaged professionally in investment business under an Act (The Investor Protection Act), replacing, with a wider coverage, the Prevention of Fraud (Investments) Act 1958 and providing for a comprehensive system based, so far as possible, on self-regulatory agencies recognised by, and under the surveillance of, a Government Department or Agency. In the light of the consultations Professor Gower now accepts that, in view of the way in which the investment industry has developed, initially such self-regulatory agencies will have to be based on existing professional institutions rather than on functional criteria and that in consequence there will inevitably be more than the four large agencies envisaged in the Discussion Document, that not all those requiring registration will be members of any of them, and that those who are not will have to be regulated directly by the Government or a Government agency.

<u>Chapter 3</u> discusses the relative advantages and disadvantages of leaving the Government role wholly to the Department of Trade and Industry or of setting up a self-standing Commission answerable to the Secretary of State. It concludes that if, when legislation is introduced, it is apparent that most firms will secure registration through membership of a recognised agency, so that surveillance of the self-regulatory agencies will be the main Governmental task, it could be undertaken by the Department but that otherwise a self-standing Commission would be preferable.

Chapter 4 deals with the scope of regulation under the Act and recommends that in principle this should cover all marketing activities (including investment advice) relating not only to "securities" but also to other investments such as those in commodity or financial futures, pooling arrangements or contracts linked to life insurance, but not in physical objects over which the investor will secure exclusive control. To give precision, with the necessary flexibility, to this principle, "investments", "securities" and "investment business" would be defined in the Act but with power to add to or subtract from the definitions, either generally or for particular purposes, by Regulations subject to an affirmative resolution of both Houses of Parliament in the event of additions. Employees would not require to be individually registered except for those engaged to advise on, or manage the investments of, pension funds or public investment trust companies. The Chapter also considers the extent to which the same protection should apply to professional as to private investors and recommends that there should be no distinction except for the retention of greater freedom to circulate investment information to "professionals", defined so as to prevent the abuses to which the present "professionals only" exemption has led.

Chapters 5 & 6 discuss matters relating to the suggested self-regulatory agencies. In Chapter 5 it is recommended that, while recognised, their rules and codes of conduct should be immune from competition law, that they should be entitled to apply for subpoenas to compel production of evidence needed in connection with their disciplinary proceedings, and that information interchanged by the agencies in the exercise of their regulatory powers should enjoy specific protection from suits for defamation or breach of confidence. Chapter 6 recommends that bodies might be recognised either as investment exchanges, or as agencies for the regulation of the conduct of their members' investment business, or as both, and that it should be an offence to purport to be carrying on business in the UK as an investment exchange unless recognised as such by the Secretary of State after consultation with the Bank of England. Recommended criteria for recognition, whether as an investment exchange or as an agency, are suggested. They would include satisfying the Department (or Commission) that the agency's rules: did not impose restrictions on competition greater than were needed for the adequate protection of investors and the orderly conduct of the relevant business or market; provided protection for investors at least equal to that afforded by the Rules of the Department (or Commission) applying to those registered directly: and would be adequately monitored and enforced by the agency. If the Government regulator was the Department, an expanded role is envisaged for a strengthened Council for the Securities Industry as co-ordinator of the self-regulatory side of the system and the link between it and the Governmental side.

<u>Chapter 7</u> deals with direct registration, with the Conduct of Business Rules to which those so registered would be subject, and with the maintenance of a comprehensive computerised register (open to public inspection) of all those registered for investment business, whether directly or through membership of a self-regulatory agency.

Chapter 8 discusses problems relating to the two main types of collective investment undertakings - insurance-linked investments and unit trusts or mutual funds. Among the many recommendations are those designed: to control more effectively the activities of unauthorised life offices and of insurance intermediaries; to relax the present tight Departmental control of the authorisation of unit trusts, delegating this to a recognised self-regulatory agency established by the industry; to permit the incorporation in the UK of mutual funds; and to harmonise the types of underlying investment permissible, whether offered through unit trusts, mutual funds or insurance-linking. Other recommendations are: that the Secretary of State should be empowered to promulgate regulations controlling the maximum commissions payable to tied or independent intermediaries and that this power should be exercised to the extent necessary to enable effective control to be exercised so far as possible through self-regulation by the industry; that unsolicited "cold-calling" for sales of investments should be prohibited by the Act except to the extent allowed by Regulations, which should permit it in respect of authorised life insurance or unit trusts but not otherwise; and that the ten-day "coolingoff" period should be extended to cover sales of single-premium policies and of trust units, but that, in their case, the investor should be entitled to the return only the lesser of what he had paid or would have had to pay had he bought on the day of cancellation.

Chapter 9 deals with public issues of securities, takeovers, and insider-dealing and recommends that the statutory provisions on these matters should be transferred, in a modernised form, from the Companies Acts to the Investor Protection Act. While no substantial amendments are recommended in respect of insider-dealing, a harmonised system is suggested for regulating invitations to the public whether on an issue or a takeover. The case for pre-vetting of prospectuses and for subsequent surveillance of the companies concerned and of any market-makers in the securities is stressed, particularly in the light of

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the statistics in paragraph 9.17 which show that some 30% of filed prospectuses relate to securities which are not to be officially listed or dealt in on the USM - a percentage which is likely to increase in the light of the Business Expansion Scheme. A system is recommended whereby supervision would be exercised by The Stock Exchange, in respect of listed or USM securities, and by the CSI and the Takoever Panel in respect of issues undertaken through members of self-regulatory agencies represented on the CSI.

<u>Chapter 10</u> discusses offences and enforcement. It recommends: substantial changes to the present prohibition on the issue of investment circulars and advertisements; enhanced powers to obtain information, and to control the activities of investment firms in financial difficulties; greater co-ordination between the various authorities, with the primary aim of putting the unfit out of business as rapidly as possible; enhanced civil remedies; and re-consideration of the methods of trial for commercial fraud.

The concluding <u>Chapters 11 and 12</u> draw attention to various matters which may need attention by others and discuss the geographical coverage of the proposed Act which, it is recommended, should be introduced as a UK Act. Throughout the Report emphasis is laid on the need to tackle effectively the "off-shore" problem and to encourage reciprocal arrangements between countries having effective regulatory systems.





NBPM BT 24/12

### DEPARTMENT OF HEALTH & SOCIAL SECURITY

Alexander Fleming House, Elephant & Castle, London SEI 6BY

Telephone 01-407 5522

From the Secretary of State for Social Services

The Rt Hon Norman Tebbit MP Secretary of State Department of Trade and Industry 1 Victoria Street London SWI

22 December 1983

GOWER REPORT ON INVESTOR PROTECTION

Your Private Secretary wrote on 24 November seeking agreement to publish the Gower Report as a Command Paper. I see no reason to dissent from this course.

The letter also referred to the possibility of your making a short statement indicating that the recommendations are open for comment and offering consultation. As the recommendations do not conflict with my own proposals in this field, I am content with this course. If any of the comments received were to come within my own responsibilities, then no doubt they would be sent on to my Department. I note also that you would propose to circulate a draft of your statement in due course. On this basis I am happy with your proposals.

I assume that the way is now clear for my Department to resume preparation of the consultative document which I propose to circulate in the New Year on such matters as disclosure of information, clarification of responsibilities, and register of pension schemes, on the lines indicated during our recent H Committee discussions. I shall be getting in touch with you about this before long.

I am copying this letter as in the previous correspondence.

NORMAN FOWLER



### 10 DOWNING STREET

From the Private Secretary

5 December 1983

### Gower Report on Investor Protection

The Prime Minister has seen your letter to John Kerr of 24 November and is content with the way your Secretary of State proposes to handle the Gower Report. She looks forward to seeing a draft of the statement in due course.

I am copying this letter to John Kerr (HM Treasury), Janet Lewis-Jones (Lord President's Office), David Heyhoe (Lord Privy Seal's Office), Steve Godber (Department of Health and Social Security), Mike Corcoran (Mr Hayhoe's office) and to the Chief Executive of the Stationery Office.

MR. A. TURNBULL

Callum McCarthy Esq Department of Trade and Industry.



Treasury Chambers, Parliament Street, SWIP 3AG 01-233 3000

29 November 1983

M C McCarthy Esq Private Secretary to the Secretary of State Department of Trade and Industry

1/12

Dear Callum,

Thank you for your letter of 24 November about your Secretary of State's wish to publish the Gower Report as soon as possible, as a Command Paper, and without committing Ministers in any way on its content.

The Chancellor is content with this proposal and assumes that Treasury officials will be consulted about policy issues and public statements in the usual way.

I am sending copies of this letter to Andrew Turnbull at No 10, Janet Lewis-Jones (Lord President's Office), David Heyhoe (Lord Privy Seal's Office), Steve Godber (DHSS), and Richard Hatfield (Cabinet Office).

Janem,

J O KERR Principal Private Secretary

Prine Minister Agree X? AT 25/



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Secretary of State for Trade and Industry

J O Kerr Esq HM Treasury Parliament Street London SW1 DEPARTMENT OF TRADE AND INDUSTRY 1-19 VICTORIA STREET LONDON SWIH 0ET

> TELEPHONE DIRECT LINE 01-215 5422 SWITCHBOARD 01-215 7877

> > 24 November 1983

Us ms

Dear John,

GOWER REPORT ON INVESTOR PROTECTION

I understand that Professor Cower is likely to deliver his Report on Investor Protection to my Secretary of State in the course of the next week or so. I hope that it will be possible to circulate a few copies to interested Departments within a few days.

2 My Secretary of State has it in mind to publish it as soon as that can be arranged and will make a short statement indicating that the recommendations are open for comment and offering consultation. We will of course circulate a draft at the appropriate time.

3 The purpose of this letter is to deal with the mechanics of publication. We believe that the Report will attract wide interest in the City and more generally and that it would be right to publish it as a Command Paper. This would emphasise the importance of the subject matter but would not of course commit Ministers in any way to the content of the Report.

4 Would you please let me know whether this would be acceptable to the Chancellor?

5 I am sending copies of this letter to Andrew Turnbull at No 10, Janet Lewis-Jones (Lord President's Office), David Heyhoe (Lord Privy Seal's Office), Steve Godber (DHSS), Richard Corcoran (Mr Hayhoe's Office) and to the Chief Executive of the Stationery Office. I should be grateful if they also would let me know whether their Ministers are content that we should proceed in this way.

Yoursever

Callin McCarty

M C McCARTHY Private Secretary

