



10 DOWNING STREET

From the Private Secretary

Prime Minister ②

This paper fulfils two requirements

(i) it provides a summary of the consultative document which the Stock Exchange will shortly be issuing on its future

(ii) it provides a view on the proposals contained in the Gowers report, on which Sir Walter Salomon commented in his speech.

BF / Agree we send a letter to DTI, setting out the case made in John Redwood's note?

Yes not

AT

6/4

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

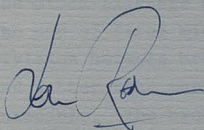
activities is such that it allows changing businesses to flourish, whilst offering individuals clear protection against fraud, embezzlement and crookedness. It should be a common law matter if a company running somebody's investments fails to keep that individual's money separate from the business's 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.

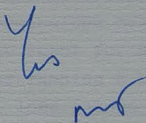
You should not be too worried about the possibility of foreigners coming in and buying up the British financial system. They have shown a certain reluctance to do so so far. They have wisely decided that buying stockbrokers and stock-jobbers at expensive prices now, reflecting the enormous profits they 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:

- i. Liquidity. Investors and issuers of securities need a 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.
- ii. Investor protection. This depends on proper dissemination of information about market deals as well as supervision of members of the Exchange.
- iii. Natural evolution and balance. A rather vague test which could 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:

- i. 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 non-member 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

Prime Minister ④

AT

WALTER SALOMON

AT
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PRIVATE AND CONFIDENTIAL

28th March, 1984

Dear Mrs. Thatcher,

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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.

Yours ever
Margaret Thatcher

Andrew - can
you let me have
a note on the
cover Report was
in Unit's Policy
note. not

The Rt. Hon. Mrs. Margaret Thatcher, MP

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 entrepreneurial 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
"Fair Warning"
October.

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.

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 Röpke 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 Röpke 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 Röpke 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. The 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 available 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 Röpke 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.

Gower in the real world

By Richard Lambert

I'VE just had this terrible thought. It's about the Gower review of investor protection, which seems set to form the basis for widespread regulatory reform in the City of London. From Whitehall to Threadneedle Street, just about everyone has approved the proposals.

But is it possible that they are completely, utterly, 100 per cent mad?

It is true that the professor has had a wonderful press so 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 his recommendations to the 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 practice.

Consider the key players in his scenario. There is the Department of Trade and Industry which, to put it politely, has not always been the most fast moving or astute 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 long tradition of sticking a discreet knife into any organisation which challenges its authority in the City. And then there are a dozen or more self-regulatory agencies, or SRA's as we must learn to call them.

These agencies are to be the front-line troops of the regulatory system as envisaged by Gower. Their executives will have the duty to supervise the behaviour of their members, and the authority to force them into line.

But can you believe that they will really use such powers? Maybe they will just be glorified trade associations, which will simply not put forward contro-

versial rulings that might upset their members. And it will be very awkward to put together a group which will be large enough to have some meaning and yet small enough to ensure 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 wide range of sometimes conflicting interests among its 16 members.

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 be reported to the Council for the Securities Industry."

Screams of terror as the picture fades.

My Terrible Thought is that the Gower proposals involve such a disparate group of regulators, and such a wide range of agencies—one can imagine a merchant bank having to join four or five SRA's—that the whole thing will be unworkable.

What are the weaknesses in the present system which this framework is meant to correct? One is the disreputable behaviour of fringe investment management groups, which has largely resulted from the fact that the Prevention of Fraud (Investments) Act is decades out of date. The other is the potential conflicts of interest in the City, which will intensify as traditional barriers between different financial institutions crumble and disappear during the next two years.

There are three ways of approaching these growing regulatory problems. One is to do nothing at all, which is unacceptable. Another is to set up a statutory agency, which still seems undesirable. The third is to go for some sensible compromise between the two extremes.

I don't know for certain that the Gower scheme is not sensible. But the more you think about it, the more wobbly the structure seems.

FINANCIAL TIMES

March 13 1984