Andrew Turnbull

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City –

10 DOWNING STREET

4 May 1984

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

Dear Alex,

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.

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 cartels 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.

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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 information and competition. 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:

i. 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

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.

11. 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.

15. 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.

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DAVID WILLETTS

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