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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.

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Prime Minister (2)

Agree the approach worked out between Mr Tebbit, Chancellor and Governor?

AT 13/7

MR TURNBULL

13 July 1984

FINANCIAL SERVICES DEBATE

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.

David Willetts

DAVID WILLETTS

CIO

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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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12 July 1984

Department of Trade & Industry

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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;

(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

6 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;

(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

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

ANNEX A

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.

4 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 securities	The Stock Exchange 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 commodities and financial futures	Dealers and brokers in commodities and financial futures LIFFE
4	Marketing of collective investments and insurance	Insurance and unit 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.