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The Rt Hon Nigel Lawson MP  
Chancellor of the Exchequer  
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*D. Nigel.*

FINANCIAL SERVICES: A NEW POLICY

You and I are to meet the Governor of the Bank of England on 11 July to discuss a number of subjects, including the financial services sector. In the Commons debate on financial services arranged for 16 July I shall want to give the House an indication of our approach. The enclosed note sets out in paragraph 6 what I consider to be our policy objectives, as announced in my speech at Touche, Remnant on 26 June. It also suggests the policy which I should outline to the House.

2 The policy approach which best fits in with our philosophy is, in summary, more vigorous enforcement of the law against fraud, and fuller disclosure of information to permit the freer operation of market forces and competition. In addition we need measures which are largely administered by the securities industry itself through self-regulation to prevent fraud.

3 I am copying this letter and the note to the Prime Minister, the Governor, the Lord Chancellor, the Attorney General and Sir Robert Armstrong. I also intend to let our other colleagues know of the line I propose to take in the debate after the meeting on 11 July.

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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

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 nor to 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.

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## 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.

9 JUL 1984

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