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*Secretary of State for Trade and Industry*

22 April 1986

The Rt Hon The Lord Hailsham of
St Marylebone CH
House of Lords
LONDON
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Dear Quintin,

FINANCIAL SERVICES BILL: SROS' LIABILITY FOR DAMAGES

A problem has arisen on this Bill about the liability of self-regulating organisations (SROs) for damages. Decisions will need to be taken quickly as we need to agree on the line to be taken on this issue when the Bill is considered on Report, which could be any time after 28 April.

As you know, the Bill provides that a designated agency shall not be liable for damages for anything done (or not done) in good faith in carrying out the functions transferred to it by a delegation order. This exemption applies to the Agency and its members, officers and staff. There is a similar exemption for the competent authority for listing purposes under Part IV of the Bill, but no exemption for recognised SROs, investment exchanges, clearing houses or professional bodies. In writing to you last autumn about the exemption for the designated agency, Leon Brittan explained that he intended to resist extending the exemption to recognised bodies on the grounds that they were not exercising statutory powers and that the collapse of such a body would be less disastrous than the collapse of a designated agency.

Contrary to our expectations, there has been no criticism of the exemption from liability for a designated agency. This exemption has been accepted as being necessary and desirable to enable the agency properly to perform its regulatory duties. There has, however, been increasing pressure to extend the exemption to recognised SROs. We successfully resisted an amendment to this effect in Committee but most of the new potential SROs had then barely started to consider the Bill. We have now had a combined

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approach from all the organisations which are expected to be candidates for recognition as SROs seeking an exemption on the lines of that given to a designated agency. They have supported their approach by sending me a legal opinion on the liabilities to which the organisations, their members and staff would be exposed if such an exemption were not granted. I enclose a copy of the letter and opinion. This approach is supported by the Governor of the Bank of England and Sir Kenneth Berrill. It is also winning increasing support in Parliament, including from our own backbenchers, and I am expecting to be pressed hard on it on Report.

I am very conscious of the need to be cautious about any extension of exemption from liability. But having considered the representations made to me, I have reluctantly come to the conclusion that in the interests of creating an effective supervisory system, an exemption should be given to recognised SROs similar to that granted to a designated agency. My reasons are as follows:-

(i) I am advised that the analysis in the legal opinion obtained by the SROs is broadly correct. The only caveat, on the law, as opposed to the weight to be given to various factors, is that the opinion does not consider whether a recognised SRO might not be subject only to public law remedies in the exercise of its functions under the Bill. Even so, the question of damages would remain just as acute. In an increasingly competitive market and with a growing number of international participants the risks are real ones. (We understand that the New York Stock Exchange has an average of 100 claims outstanding against it at any one time, even though it has never lost , or conceded a case. The US commodity and futures SROs, which were set up under more recent legislation than the NYSE, are exempted from liability). The writs issued against individual members of the LME governing body have demonstrated the vulnerability of individuals as well as of organisations. I also accept that adequate insurance cover can no longer be obtained, even by established regulators, let alone by new ones.

(ii) The success of our new arrangements for regulating investor business depends on having well-run SROs covering all the main types of investment business. This involves persuading first class people to serve as members of the governing bodies. It is clear from the SROs' letter that



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we are unlikely to achieve this objective unless we provide protection both for individuals and the organisations.

(iii) The functions which recognised SROs will perform under the Bill are very similar to those of an Agency. They will be responsible for authorising and regulating investment businesses and although, unlike an Agency, they will not be exercising statutory powers, they will be required, as a condition for recognition, to have and enforce rules which provide equivalent protection for investors. Supervisors can exercise their powers more effectively if they are not under constant threat of legal action. It is difficult to justify protecting one type of supervisor and not another doing a similar job. Also, we no longer think that we can give much weight to our argument about the collapse of an SRO. The collapse of a recognised SRO, although not, as disastrous as the collapse of an Agency, would still have very serious consequences for the regulatory system.

(iv) We want to encourage investment businesses to become members of SROs rather than to seek direct authorisation. There will, however, be a strong incentive to go to SIB if membership of an SRO, but not direct authorisation, exposes businesses to the risk of a surcharge to meet a successful claim for damages against the SRO, perhaps made by a competing firm.

I am satisfied that private investors would not suffer unduly if an exemption from liability were granted. Their first recourse in the event of loss will be against the investment business concerned. If the business is insolvent, there will be arrangements for compensation. As a condition for recognition, SROs will be required to have compensation arrangements which provide protection for investors equivalent to the Agency's arrangements. As you know, the SIB is planning to establish a fund which will meet at least 90 per cent of any claim from a private investor up to £30,000. The SROs' arrangements will have to match this provision. It is therefore only as a last resort that a private investor would need to recourse against the SRO itself.

As to accountability, the SROs will, as a condition of recognition, be required to have rules which provide protection for investors equivalent to that provided by the Agency's rules and to enforce those rules effectively. There must also be a proper balance on their governing bodies, including independent representation, to

ensure that the interests of investors are given due weight. The Agency can withdraw recognition or seek a compliance order if any of these requirements is not satisfied. I think that this will provide adequate safeguards if an exemption from liability for damages is given.

I apologise for the length of this letter but the issues are complex and I thought that it would be helpful if I set them out in full. If you find any difficulty with what is proposed, then Michael Howard or I would be glad to discuss the issues with you.

I am copying this letter (but not the enclosure) to the Prime Minister, the Lord President, the Chancellor of the Exchequer, the Home Secretary, the Lord Privy Seal, the Chancellor of the Duchy of Lancaster, the Attorney-General, the Chief Whip, the Governor of the Bank of England and Sir Robert Armstrong.

PAUL CHANNON



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