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17. 2.83

THE GOVERNOR

Copies to The Deputy Governor
Lord Benson
Lord Croham
Mr Dawkins

CITY PROBLEMS AND THE HOWDEN CASE

1 You are due to see the Chancellor and Lord Cockfield at 4.00 pm on Thursday, 24 February. Some issues under this heading may also arise in your earlier bilateral session with Lord Cockfield on the previous day, though you will no doubt want to reserve your main contribution for the Chancellor at the No 11 meeting.* Annex A, prepared by DAD, sets out specific points on the Chancellor's questions, but I imagine you will want to preface these with some broader comment:

(a) to put concerns that have been expressed in perspective;
(b) on the respective roles of self-regulation and government regulation under statute; and
(c) the Bank's view that, in parallel with the development of self-regulation, vigorous official action is needed in respect of fraud.

Perspective

2 There is a common though usually fairly unspecific concern that the protection afforded to private investors in securities and similar assets should be strengthened. One element is that, as new investment instruments and techniques have developed, gaps of coverage may have emerged both within the statutory framework for regulation and between government and self-regulation.

3 But though there is an entirely reasonable concern to provide for matters such as the secure separation of clients' monies, where such assurance does not already exist, the discussion needs

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*There is separate briefing on the Restrictive Practices case and on recent developments at Lloyd's.

perspective. There is an emotive appeal in the clamour for better protection which tends to disregard that the extent of any mischief of which widows and orphans and others have been the sufferers has been very small indeed in relation to the overall scale of securities business that is transacted by market practitioners. There is an important distinction to be drawn between the popular perception of the extent and nature of the problem and the specific parts of it which call for a strengthening in regulation. Opinion has been fed by misinformed comment in the press and even by the judiciary. Two years ago, the Norton Warburg case was seen by some critics as a failure of self-regulation notwithstanding that the company was regulated by the Department of Trade as a licensed dealer under the PFI Act. Very recently, the judge in his summing up in the recent Miller Carnegie fraud case referred in very critical terms to the regulation, or lack of it, in the London commodity markets. But the defendants were not members of any of these markets and could not therefore be covered by the self-regulatory arrangements which govern the behaviour of their members.

4 There are some areas of activity that are beyond the reach of self-regulation in the normal sense. High Street commodity advisers and traders are a topical example of a group whose regulation probably can only be on the basis of statute: the deficiency here is in the ambit of the relevant statute, not in self-regulatory arrangements. Self-regulation within peer groupings such as the Stock Exchange and the Accepting Houses Committee aims at maintenance of high standards of conduct among the large majority of practitioners who abide by them. That breaches of these codes have been relatively rare is evidence of good self-regulation. Minor breaches are dealt with effectively by procedures (for example, a private meeting between the chairman of the Stock Exchange and the senior partners of a member firm) which, properly, attract no publicity. But where there have been breaches of a more serious nature, the sanctions of self-regulation have been applied with considerable vigour and effect; for example, by the Stock Exchange in the cases of Hedderwicks and of Halliday Simpson and, more recently, the case involving a

resignation or dismissal from Buckmaster and Moore and Akroyds and the expulsion from the Stock Exchange of the employees concerned.

The roles of government and self-regulation

5 Leaving aside the pursuit of criminal fraud, is it supposed that government regulation could do better? Government regulation should cover requirements which are fundamental in character, the breach of which may be treated as a criminal offence. Some specific mischiefs are probably better guarded against by statute; insider trading is the main recent example of a transfer from self-regulation to statute. But regulation that is closely based on statute tends unavoidably to be both heavy-handed and niggling, and cannot be as effective as the best self-regulation at striking the right balance between satisfactory regulation and allowing the continued efficient conduct of business.

6 At its best, self-regulation endeavours to secure the highest standards of conduct by laying down principles that are accepted by those who subscribe to it. It is decisive and tends to be tough on those who break the rules. It tends to operate at the frontiers of regulation where innovation and flexibility are required to a degree not easily attainable by statute, even when supplemented by a power to make subordinate legislation. The functioning of the Panel on the basis of the takeover code is perhaps the clearest example. But another is the listing agreement of the Stock Exchange, the rules of which are the subject of continuous reinterpretation by the Quotations Committee as the needs and circumstances of individual cases change. Of very recent origin, the rules for substantial acquisitions have been developed by the CSI over the past 2-3 years to combat the problem of market raids which scarcely existed previously. Contrast all this with the cumbersomeness of the revision of the licensed dealers' rules under the PFI Act - a process that has been in tran for well over a year and is still incomplete. This is not a criticism of those involved but underscores the inevitable delay in a formal process

of consultation requiring legal drafting to a high degree of precision of rules which, once promulgated, cannot readily be changed.

7 The foundation of effective self-regulation is that those concerned share a common interest in maintaining standards of conduct in the business in which they are engaged and a readiness to act collaboratively to deal with problems effective as they arise. This applies both to problems that arise among members of a market, whether this exists in the formal sense or otherwise, and those that arise between that market and the general public. But self-regulation well not be effective if market participants with substantially disparate interests in terms of the scale, nature and style of their business are corralled into groups put together solely for the purpose of self-regulation. There has to be a large element of naturalness and spontaneity in self-regulation and the original Gower proposition, effectively that self-regulation be compulsory, is a contradiction in terms. Self-regulation can be imposed, but it will not then be self-regulation.

8 Within the major issues:

(a) The regulatory structure of the Stock Exchange, involving in particular single capacity, severe limitation on the outside interests of members and the compensation fund, is highly developed; it can and does cope with regulatory problems that arise within the market and the most serious threat to the continuing authority of the Stock Exchange to perform its regulatory role comes from without, in the shape of the RP reference.

(b) Impressively vigorous activity is in train to beef up the quality of regulation at Lloyd's under the powers that are now available, including in particular separation of capacity - much harm has, alas, been done by the inadequacy of regulation earlier, but there seems no want of determination to make amends now.

(c) Members of the commodity futures markets are firmly committed to introduce within the next few months compensation arrangements for their private clients; and

(d) Work continues under the auspices of the CSI to develop codes, for example on discretionary investment management, to which the clearers, merchant banks, Stock Exchange and members firms and others committed to the CSI are expected to subscribe.

9 Beyond all this activity to strengthen self-regulation, there is need for some modification of the PFI Act, for example to cover investment management as well as dealers in securities; and there is a need to extend statutory control to fringe operators in commodities (eg Miller Carnegie) who are not members of markets and could not be brought within the ambit of their regulatory arrangements.

Financial fraud

10 None of this relates to the adequacy of existing provision for the investigation, prosecution and Court procedures for fraud cases. This separation is indeed appropriate for, whereas good regulatory arrangements, whether in the form of self-regulation or regulation by government, should materially lessen the risk of fraud, the sophisticated and determined financial fraudster is unlikely to be frustrated by standard regulatory procedures if he is undeterred by the risk of criminal sanction. Good regulation is a good preventive of fraud, but the ultimate sanction is a matter for the criminal law. As was pointed out by the CSI in its initial comments on the Gower proposals, the delay and uncertainty of present procedures to deal with financial fraud is a major weakness. This has clear relevance for those concerned to strengthen self-regulation; there is arguably little merit in improving the finer points of conduct if gross fraud goes unpunished. The Bank takes a similar view, which is indeed sharpened by the apparent (if not certain) increase in the frequency and sophistication of financial fraud, and which has a growing international involvement.

11 With all this in mind, we have for some time felt the need for a vigorous and comprehensive enquiry in this area, and we welcome the interdepartmental exercise that has now been mounted. We hope that this will generate early progress at least in respect of better communication and better coordination of resources involved in fraud investigations, even though other issues such as Court procedures and possible abandonment of the jury system in such cases do of course pose much larger problems. Much of this goes well beyond the ambit of the Bank, but we will continue to make the contribution that we can to help in taking this work forward.

17 February 1983

ANNEX A

CITY PROBLEMS AND THE HOWDEN CASE

1 This note takes the specific questions raised in the Chancellor's letter of 24 January and suggests what might be said in response.

a(i) Do we take effective action fast enough?

2 In the Howden case, the Bank was in close touch with Whitehall from the outset and urged the case for a Section 165 investigation subsequently several weeks before this course was determined: the Bank also pressed - only partially successfully in the event - for speedy and effective action to prevent the destruction of papers.

3 The Bank identified at an early stage the need for Lloyd's to have a Chief Executive. It would scarcely have been possible to find the appropriate candidate and obtain Lloyd's agreement more quickly than in fact has been done.

a(ii) Should statutory powers be used more promtly or posively?

4 As regards the Howden case, we do of course recognise the limitations on S109 powers in securing the protection of documents and we certainly accept that such powers cannot be invoked without adequate information. On the other hand, we understand (from a recent DoT paper) that more extensive use of S109 would be valuable but is limited by the availability of resources. Any final judgment on whether or not prompter use of Section 109 powers would have been helpful in the Howden case will have to await the outcome of the present investigations.

5 More generally, one of the causes of delay in the investigation of fraud is said to be the failure of inspectors appointed under Sections 164 or 165 of the 1948 Act to avail themselves quickly

enough of the powers given under Section 41 of the 1967 Act to inform the DoT at any time of matters tending to show that an offence has been committed. However, we understand the situation is improving.

6 With regard to commodities, once the instrument exempting members of markets from the Banking Act is in force, the Bank will be in a better position to pursue any fringe operators who, although not covered by the exemption, continue to take margin in the form of deposits. But the Banking Act does not provide powers to cover operators who (as in the Miller Carnegie case) are selling commodity options - see a(iii) and a(iv).

a(iii) Do they (statutory powers) need to be changed?

7 It is widely accepted that the PFI Act needs to be amended. As a minimum, its scope should be clarified (eg its application to investment management and possibly advice) and the powers of the DoT over licensed dealers strengthened. In the meantime, the issue of new (and improved) licensed dealers' rules under the existing PFI Act, is still awaited - although we hope the final version will not attract the same widespread criticism of overkill as the most recent draft.

8 There is a need to extend statutory control to fringe operators in commodities who cannot be caught by self-regulatory arrangements (see following paragraph).

a(iv) Is other non-statutory action indicated?

9 There are areas in which self-regulation can be and is being improved. In particular, the CSI is working on a code of investment management; and the various futures markets in London (London Commodity Exchange, London Metal Exchange, Grain and Feed Trade Association, London Gold Futures Market and London International Financial Futures Exchange) are jointly planning the introduction of arrangements for protection of clients, including compensation for those who incur losses as a result of a member's insolvency. Self-

regulation cannot, however, reach fringe operators like Miller Carnegie (who were not market members and were not so far as we know taking margin in such a way as to bring them within the scope of the Banking Act).

b(i) Do the arrangements for consultation and communication of information between HMT, DoT and Bank work as effectively as they should in cases of this kind?

b(ii) Do they work fast and early enough in cases of urgency?

10 We are not aware of any general impediment to prompt and effective communication and consultation on such matters between the Bank, HMT and the DoT.

b(iii) Do they work clearly? Could they be improved by greater use of written information to avoid ambiguity about the views or intentions of any of the parties?

11 The provision of information in writing can itself be a cause of delay but, that said, the Bank will, wherever practicable and appropriate, supplement oral communication on such matters with a follow-up or confirmation in writing.

c Are we satisfied about the clarity and timing of arrangements to ensure that the police are properly informed where there is the possibility of criminal liability?

12 Because of its responsibilities under the Banking Act, the Bank may become aware of offences for some of which it may also be the prosecuting authority. Any other offences can readily be referred to the police, though the Bank is not often in the position of being the natural informant. It would be useful if a clear channel of communication to the police could be established; one possibility might be to do this via the DoT; another would be through the office of the DPP.

d(i) Are there areas of City business for which responsibility within government is not sufficiently clearly defined?

13 We do not accept the implied proposition that a clear government responsibility should be assumed for every area of City business. The most valuable contribution government could make on the problems with which we are concerned here would be to remedy the deficiencies in the present arrangements for detecting, investigating and prosecuting cases of financial fraud. We are glad that this question is now receiving the attention it merits.

14 That said, the Miller Carnegie affair points to one specific area, albeit a narrow one, where there is in our view a clear case for assumption of responsibility by government.

15 Although it is in no sense exclusively "City business", we have been concerned about inadequacies in the supervision of and in the law relating to pension funds. We are glad that this too is now receiving attention in a working group under DHSS chairmanship in which the Bank participates. To assist the work of this group, the Bank is organising a seminar to review major issues.

d(ii) Does this create a danger that action will not be taken quickly or positvely enough to prevent a scandal or crisis or to deal with it promptly if it occurs?

16 The possibility of a breach of rules or serious misfeasance can be minimised though it cannot be eliminated. Those concerned in self-regulation must be continuously attentive to ensure such risk minimisation, both in observance of existing rules and codes and, where they are needed, in developing new ones.