



10 DOWNING STREET

Prime Minister

Financial Markets and Building Societies.

Policy Unit has drawn together notes on various developments in financial markets. Specific responses are sought from you on

- Building societies
- Investigation of fraud

The notes on

- Fraud and investor protection
- Stock Exchange

precede submissions from DTI.

A number of key questions could be raised at the lunch with Baring's.

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THE CITY

Several City matters will be coming up in the next few weeks:

- Chancellor has minutes on this.
- The Chancellor's proposals for more effective investigation of fraud.
 - A decision on what steps should be taken to reform the law on investor protection following the Gower Report.
 - Enclosed | - The publication of a Green Paper on the future of building societies.
 - The Stock Exchange council should set out its views on the future structure of the Exchange following its April Consultative Document.

Mr Tebbit wants a major debate in the House of Commons before the summer recess, when the Government will need to set out its thinking on all three issues.

These topics are part of much wider changes in the world of finance. It is not up to the Government to formulate some blueprint of what should happen in fast-changing markets. But the trend towards financial conglomerates, as in the

USA, is unmistakeable. This means big organisations with large capital resources and good contacts with the major institutions. They might act as financial advisers to a company, raise money for the company, and then make a market in its shares and other financial instruments. At the retail level, financial "supermarkets" should make "one stop" financial shopping possible. The local branch of a bank or building society could handle banking requirements, advise on how best to invest savings, help insure a house, and carry out Stock Exchange transactions. The attached note shows what a conglomerate might do.

The sceptics argue that the conflicts of interest in financial conglomerates are so acute that they will not prove workable. But American experience doesn't bear this out. Any firm involved in shady dealing or selling pups to an investor would rapidly lose business. Conflicts of interest exist already within many merchant banks; they would be more difficult to exploit if vigorous disclosure is required. If a merchant bank places shares to raise money for a corporate client by selling them to its investor client, we need clear disclosure of its interests and of the price and timing of the deal.

There should be four main themes to the Government's approach to financial institutions. They provide the criteria against which the particular proposals put to you could be judged.

First, the Government should do nothing to obstruct the free operation of commercial forces. The financial sector accounts for about 13 per cent of GDP and contributes £1.5 billion to the balance of payments. It is a successful, profitable area of the economy which should not be stifled by over-regulation. It is rivalled only by micro-electronics and information technology as a booming area of the British economy. The Government should reap political benefits from associating itself with this success story.

Secondly, financial services should be in the forefront of competition policy. The City has a dangerous tendency to favour the cosy, clubby cartel. The Stock Exchange has been outpaced by New York over the past 10 years because of this. The sudden release of energies in the Stock Exchange following Cecil Parkinson's pressure on them is a good example of what can be achieved - dealing fees will come down, and the range of services expand. The forthcoming legislation on building societies is another opportunity - they strengthen their role as providers of housing finance and are free to compete with local solicitors, estate agents and, in some areas, banks.

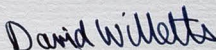
Thirdly, individual share-ownership is a major Government policy. Many factors will help push it forward, ranging from second-generation home-ownership (with the prospect of

inheriting capital that can be invested in shares) to low inflation, improved industrial performance, and a growing aspiration to have a say in the business.

But changes in the financial sector should also help. There is a large potential retail market which conservative British firms have been reluctant to exploit. Banks and building societies have extensive retail networks, with under-employed and unionised staff. They will either have to cut them back or use them more intensively to market a wider range of financial services. If they don't, the Mark Weinbergs of this world will outwit them by using outlets like stores to provide these services.

Maximum disclosure of information. City operators like operating behind closed doors and giving their trade an unnecessary mystique. This increases the risk of malpractice or of overcharging, and puts Mr Everyman off. Wherever possible we should press for the maximum possible information in the most digestible form.

The most ruthless guardians of the customer's interest are competition and disclosure. The attached notes apply these principles to the Gower Report on Investor Protection, Building Societies, and the Stock Exchange.



JOHN REDWOOD/DAVID WILLETTS

WHAT A CONGLOMERATE COULD DO

<u>The Activity</u>	<u>Existing Institutions</u>
<u>Banking</u>	
Money transmissions and current accounts	Clearing Banks
Deposit accounts	Merchant Banks
Overdrafts	
<u>Investment</u>	
Advice on a transaction in stocks and shares	Merchant Banks Stockbrokers & Jobbers Investment Houses, Banks and Brokers
Investment vehicles (unit trusts, etc)	
<u>Property</u>	
Surveying and estate agency	Building Societies Estate Agents Lawyers
Conveyancing	Surveyors
Property development	Investment Managers
<u>Insurance and Saving</u>	
Life	Composite Insurance Companies
Pensions	Lloyds
General	Life Companies

FRAUD AND INVESTOR PROTECTION

Mr Tebbit will be putting forward to you next week his views on how to sort out the existing messy law on investor protection. The Chancellor should be putting forward to you today practical proposals for improved investigation and prosecution of fraud.

There are three different approaches which Mr Tebbit will set out:

- i. Direct regulation by DTI.
- ii. A set of self-regulatory agencies covering various financial functions. They would in turn be supervised by the DTI itself, or possibly some intermediary body along the lines of the Council for the Securities Industry.
- iii. The minimalist approach which says the consumer is best protected by information, competition, and basic legal requirements rather than a panoply of regulations, whether proposed by government or the City itself.

Mr Tebbit is likely to press for self-regulation. We still believe in the power of competition and disclosure.

Setting aside our fundamental worries about the SRA option, there are also severe doubts about its practicality. It isn't clear that the City will be able easily to organise itself into a small number of SRAs, or that they would be able to get to grips with the complexities without a strong emphasis on disclosure, competition and a law on fraud. This is the question which the Governor's informal group of experts is looking at, and which may come up at lunch at Barings on Monday.

We broadly welcome the Chancellor's practical proposals for strengthening the investigation and prosecution of financial fraud. They are the most effective way of protecting investors.

THE BUILDING SOCIETIES GREEN PAPER

We welcome the Chancellor's approach.

There are four main themes to the Green Paper:

- i. Building societies must remain a safe, reliable place for the small investor to put his savings. They don't have the management resources or skills to engage in fancy financial and lending operations risking significant amounts of their assets. The last thing we want is a building society crisis in a few years' time like the secondary banking crisis of the 1970s.
- ii. The building societies have done a lot to spread home-ownership and their activities should continue to be focussed on this key objective. The Green Paper suggests a rule that 90 per cent of building societies' assets must be mortgages on residential property. We are happy with that.
- iii. But there is scope for building societies to provide a rather wider range of services, particularly related to housing and land. So they could use up to 10 per cent of their assets for, for example, buying land and housing directly. They should also be free to engage in conveyancing and property surveying. And finally,

their retail network is well-suited to a variety of financial services like carrying out share transactions for clients, or paying people's bills by transfers. If they wanted to move into these areas, there would be more healthy competition in the high street.

- iv. The Green Paper is a prelude to new building society legislation in the 1985-86 Session, as the 1962 Building Societies Act is now very much out of date. As the financial scene is changing so fast, the new legislation must be more flexible than the old legislation was so that, where possible, regulations can be changed by Statutory Instruments rather than new primary legislation.

All these good strong themes are in the Green Paper. But we have three suggestions for livening it up.

First, it would benefit from a short, punchy Ministerial foreword highlighting the themes set out above. A lot of people won't have the time or energy to wade through the 35-page document and discover the hidden nuggets.

Secondly, the discussion of building societies' activities in Europe in Chapter 3 could be more positive. The Government is keen to argue for free trade in financial

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services throughout the community, and there is no harm in bringing out the point here.

Thirdly, the discussion of possible extensions of building society services in Chapter 4 is cautious. Instead of saying that the Government waits to hear from the societies, it should say that the Government in principle favours this subject to the views of the societies.

THE STOCK EXCHANGE

If I wish to buy a share at the moment, I have to do so through a stockbroker who is a member of the Stock Exchange. The broker acts as my agent: he seeks prices from the jobber members, and buys from the cheapest.

Throughout the transaction, the stockbroker never owns the stock. He has to ensure the best price for his client at the time, and smooth settlement of the transaction.

The jobber - or market-maker - stands ready to buy or sell shares from all comers at a price of his choosing. He is the Stock Exchange bookie. He is protected from quoting a price that is way out of line with that of the other jobbers; he is always bound by the rules of the Exchange. In return, he enjoys several privileges. He gets favourable treatment over the payment of dividends on stock he owns; he effectively escapes the payment of all Stamp Duty on his holdings; and, most important of all, the jobber is told about any broker-to-broker deal (order exposure) and can insist on buying or selling stock with one of the dealing brokers at their chosen price.

For the individual client, this system has some disadvantages:

- he cannot negotiate direct with the jobber from whom he is buying his share
- he is paying commission to the stockbroker and the jobber's "turn" (the gap between the price at which he bids for stock and the price he offers back)
- the stock-jobbers do not have enormous capital resources to back them up, so it may be difficult to deal in large size in many company securities.

Forthcoming changes in the system

The system is now being torn apart as a result of the OFT case. The separate functions of jobbers and brokers will go. Many small stockbrokers are worried that they will lose out, as they team with banks and/or jobbers to make markets in a whole range of securities. Small broker backwoodsmen are now well represented on the Stock Exchange Council. They will be advocating a traditional role.

Some fear the Market's liquidity will dry up under this new system. There is, so the argument runs, a range of second-line stocks dominant in number but not in turnover, where the new market-makers would not be interested in always being ready to buy or sell. But the present system is hardly ideal. You can only deal in very limited size in most small company stocks. And if anything, the overall

effect of the new system will be to increase market liquidity because (a) costs of dealing will fall, encouraging more turnover; and (b) there will be more risk-takers running a barrow in the market.

The backwoodsmen want a compromise; of a two-tier market with an upper tier of highly-traded stocks being traded by combined broker-jobbers; and in the first instance, a second tier of stocks handled through a system reminiscent of the current one. We should be extremely wary of it. It would only be a compromise related to the faction squabbles of the Stock Exchange: it would have little basis in logic. Second-line stocks would soon be traded like first-line stocks.

What should the Government's role in all this be?

The Government should protect the customer by insisting that dealers reveal all, and seeing sufficient competition in the system, so that commissions and prices can be brought down. It should not plunge into the faction squabbles of the Stock Exchange and come up with a view of how the system is to operate. It should, however, be quite firm that it requires a central electronic marketplace with continuous recording of prices, volumes traded and last-trade price. It should make clear that in the revised settlement system now being put into the Stock Exchange, an individual should expect to see on his contract note the time of dealing as well as the

day, the then market price, and the price commission charged by the broker-dealer or whoever. This is the only way to protect the customer and is an improvement on the present system.

The Stock Exchange will fight to preserve the membership of the club as the regulatory body for dealing activities. The Government should not necessarily object to this, but its competition policy arm should make sure that entry to the club can be achieved on reasonable terms, and the club does not convert itself back into a price-fixing cartel.

The Stock Exchange needs to come up with working proposals for a dealing system soon. If it does not, there is a risk that the necessary computer technology for an electronic marketplace will not be in place in time for the new system to be operating by 1986.

We recommend the Government's immediate aim should be to encourage an early solution.