

A BRIEF FOR THE DEBATE ON  
THE GOWER REPORT ON THE  
REVIEW OF INVESTOR PROTECTION IN THE  
FINANCIAL SERVICES SECTOR

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# The Gower Report on the Review of Investor Protection in the Financial Services Sector

## Introduction

The rapid developments that are now taking place in the markets for financial services have made it necessary to construct a regulatory system which both allows the City to respond successfully to increased international competition but which at the same time affords sensible protection to the investor. These two objectives come together in that a market in which an investor has the confidence to invest, will also be a more competitive market internationally.

In July 1981, the then Secretary of State for Trade commissioned Professor Gower to examine the statutory protection required by private and business investors and to assess the need for statutory control of dealers in securities, investment consultants and investment managers and to advise on the need for new legislation. Professor Gower consulted extensively and received views offered in response to a Discussion Document issued in January 1982. His final report was presented to Parliament in January 1984.

Mr Alexander Fletcher, pointed to the wider significance of creating a system that had the confidence of the investor when he spoke of the need to spread:

'understanding of investment and the City to the Community at large - to the many people who could afford to invest but are deterred by social prejudices or ignorance of the processes involved: people who at present have no easy access to the market place. This is the real challenge to the securities industry. Wider share ownership is not just about small investors dealing on the Stock Exchange. It is also about promoting a greater understanding of how wealth is created, how 'stocks and shares' are linked with productive capacity, earnings and employment' (Society of Investment Analysts, 16th February 1984).

## Need for Reform

The existing legislation on which investor protection is based are the Prevention of Fraud (Investments) Act 1958 and the Companies Acts. However, the rapid changes that are now taking place in the City and the incidence of fraud has made a review necessary.

DEVELOPMENTS IN THE CITY: Plans for self-reform by the Stock Exchange in the face of changes in the international securities markets have provided much of the stimulus for further change.

In July 1983 the Government announced its intention to exempt certain agreements relating to the Stock Exchange from the Restrictive Trade Practices Act 1976, in return for promises of self-reform that would see a gradual abandonment of minimum commission scales by the end of 1986. In November 1983 Sir Nicholas Goodison, Chairman of the Stock Exchange set up two committees; one to consider the methods of dealing and market making, the other to review the constitution and membership structure of the Exchange. On 12th April 1984 the product of their deliberations, 'The Stock Exchange. A Discussion Paper', was published. Among the important changes that have already been implemented, together with the ideas for reform contained in the Paper, include:

- The present system of single capacity, separating the functions of stockbroking and stockjobbing could not last, following the introduction of negotiated commission.

- The elimination of minimum commissions on bargains in overseas securities, and firm plans for eliminating minimum commission altogether.
- A relaxation of the restrictions on membership and the establishment of international dealerships.
- The introduction of lay members on to the Council.
- Plans to improve the quality and quantity of publicly available information on trades. e.g. Development of the Stock Exchange Daily Official List, to provide a better public record of business done.
- Recognition that expenditure would be required to ensure that there was adequate supporting technical systems (i.e. market information and settlement systems).

These developments, following the agreement between the Government and the Stock Exchange, offer significant indications as to the way in which essentially self-regulated systems can develop without the requirement for direct Government supervision and control. As Sir Gordon Borrie, Director-General of the Office of Fair Trading has said:

'The deal at the time didn't seem very satisfactory, because the Stock Exchange gave up only one restriction. But later the City started doing a whole number of things that are going to create competition for the benefit of users and investors and create more competition between the British and world financial markets' (Daily Telegraph, 9th April 1984).

Other important developments have been the creation of an Association of Future Brokers and Dealers (AFBD) and the revision of the constitution and rules of the National Association of Securities Dealers and Investment Managers (NASDIM). Similarly, the difficulties in the insurance industry provoked the then Department of Trade to undertake investigations into the affairs of the Alexander-Howden Group and Minet Holdings and found Lloyds of London involved in litigation with one of its underwriters, Mr Ian Posgate; since that time and the appointment of Mr Ian Hay Davison as the first chief executive of the insurance market, wide ranging reforms for improving the self-regulatory mechanisms have been set in train including proposals for new rules and regulations designed to reveal commercial relationships between working members of Lloyds and companies with which they do business.

These changes have been taking place against a background of increasing international competition; the scrapping of fixed commissions on the New York stock market, the march of technology and the consequent development of 24 hour markets have acted as a catalyst for restructuring in London.

Stock Market firms have linked up with other financial institutions. Barclays, for instance, has established a pairing with both a jobber, Wedd Durlacher and a broker, de Zoete and Bevan. This is illustrative of a trend for more broadly based financial 'supermarkets' which are perhaps best highlighted by the merger between Hambro Life and Charterhouse J Rothchild.

As the Economist has pointed out:

'In the past six months, five British merchant banks and clearers have pounced on some of London's biggest jobbers and brokers; a city money broker is opening a new stockbroking firm, the first for eight years; a Scottish investment trust has taken a stake in an Edinburgh broker; and a life assurance office has recently increased its stake in a merchant bank to just under 30 per cent' (12th May 1984).

### Objectives of Reform

The purpose of this debate is to hear the views of the House on the subject of investor protection; the Government has made no hard decisions on the form that the new system of regulation should take. But whatever structure is developed must strike a balance between over-regulation, where the financial markets are unable to respond quickly enough to keep pace with the changing requirements of investors, and a form of self-regulation where the regulators look after the interests of their own members at the expense of the investor. The Financial Times has characterised the two extremes as 'caveat emptor versus the nanny society' (30th April 1984). The Gower Report itself outlines the basic philosophy as being one where the regulation in the interests of investor protection 'should be no greater than is necessary to protect reasonable people from being made fools of' (Cmd 9125). This tacitly acknowledges that overprotection can be just as harmful to the investor by encouraging him to be less careful with whom he deals.

Mr Norman Tebbit, in a speech to the Touche Remnant International Advisory Board's conference in London on 26th June listed five main objectives in the Government's approach to the changes taking place in the City. They were:

- a financial services sector able to provide services to British industry and commerce, private investors and Government in the most cost-effective and internationally competitive way.
- freedom for market forces to stimulate competition and encourage innovation.
- a regulatory framework which provides effective protection for the investor, but not in such a way that it fails to respond to international developments and thereby becomes a screen for protectionism.
- a regulatory framework which inspires investor confidence by ensuring that the British financial services sector is both a competitive and 'clean' place in which to do business; and is clearly seen as such.
- a regulatory framework which is predictable enough to shape the structural changes in the City which are now gathering pace, but also sufficiently flexible neither to cramp this process nor to be overrun by it.

Mr Tebbit has summarised the position thus:

'Investors simply will not risk their capital in markets which are not adequately supervised. Nor will they be able to operate quickly and effectively if they are excessively supervised' (Financial Times, 15th May 1984).

### The Gower Report

THE REGULATORY SYSTEM: initially proposed by Gower in the Discussion Document was a self-regulatory system carried out by three or four functionally based agencies covering the main financial activities i.e. securities, commodities and futures, investment managers and advisers and insurance salesmen and advisers. The final Report, however, envisages a larger number of self-regulatory agencies (SRAs) based largely on existing professional groupings.

However, the Report recognises that this is not an ideal situation. It states that:

'It is regrettable since I have no doubt that senior officials from central banks and supervisory authorities in eleven countries were right in concluding, at a conference held by the Bank of England in May 1983, that: "because distinctions between types of financial institutions are becoming blurred supervision should be based on functional rather than institutional criteria ...' (Cmnd 9125).

The great advantage of fewer, but larger functionally based SRAs is that they would command more resources and therefore be able to exercise more effective control. In addition functional agencies would be less likely to be dominated by their own members, as purely professional bodies.

The Report recommends that SRAs should receive recognition only if they satisfy certain criteria, notably: the fairness of membership rules; strict regulations relating to admission that ensures that members are fit by virtue of character, training, experience and financial resources to trade; strict rules of conduct, i.e. concerning conflicts of interest, disclosure of all sources of remuneration, recommendations or advice that are unsupported by evidence; adequate safeguards for clients in the event of the collapse of those carrying out investment business; and adequate procedures and resources to effectively monitor and enforce the observance of its rules. These rules would be drawn up in such a way as to make one particular agency competent to regulate firms whose activities crossed functional boundaries.

The form of supervision of these agencies is, according to the Report, a straight choice between the Department of Trade and Industry (DTI) and a new self-standing Commission. The Report points out that the Council for the Securities Industry (CSI) would have an important role in the absence of a Commission, to assist the DTI in the 'recognition and surveillance of those agencies' (Ibid).

The statutory authority would, however, have the ultimate responsibility for recognising SRAs and ensuring that their business was properly conducted. It would also have a function to register directly, those firms that were not covered by an SRA.

The Report recommends that, initially the statutory body should be the Department, but that if, once legislation has been introduced, it is found that the day to day volume of Governmental regulation and supervision had become substantial, a self-standing commission answerable to the Secretary of State should be established.

As a review of the Gower Report by Arthur Young McClelland Moores and Co. has said:

'In essence, the Report is proposing that, within a statutory controlled environment self-regulation, which operates well in some areas, but not so disciplined at present in others, should be given a chance to prove that it can do the job effectively - if it fails, the statutory body is the only alternative' (Review Number 51, January 1984).

SCOPE OF REGULATION. The Report recommends that in principle a new Investor Protection Act should cover all marketing activities (including investment advice) relating not only to 'securities' but also to other investments such as those in commodity or financial futures, pooling arrangements or contracts linked to life insurance, but not in physical objects over which the investor will secure exclusive control after acquisition. To give precision, with the necessary flexibility, to this principle, 'investments', 'securities' and 'investment business' would be defined in the Act but with power to add or subtract from the definitions, either generally or for particular purposes, by Regulations approved by Parliament. Employees would not need to be individually registered except for those engaged to advise on, or manage the investments of, pension funds or public investment trust companies. The Report also considers the extent to which the same protection should apply to professional as to private investors and recommends that there should be no distinction except for the retention of greater freedom to circulate investment information to 'professionals' defined so as to prevent the abuses to which the present 'professionals only' has led.

#### LIFE ASSURANCE AND UNIT TRUSTS

The Report discusses problems relating to the two main types of collective investment undertakings - insurance-linked investments and unit trusts or mutual funds. Among the many recommendations are those designed: to control more effectively the activities of unauthorised life offices and of insurance intermediaries; to relax the present tight Departmental control of the authorisation of unit trusts, delegating this to a recognised self-regulatory agency established by the industry; to permit the incorporation in the UK of mutual funds; and to harmonise the types of underlying investment permissible, whether offered through unit trusts, mutual funds or insurance-linking. The Report proposes that insurance intermediaries should be governed by a code of conduct, produced by an industry body, or if not by statute, when marketing life insurance, which would include a rule that clients should have their attention drawn to all 'health warnings' connected with the policy. Other recommendations are: that the Secretary of State should be empowered to promulgate regulations controlling the maximum commissions payable to tied or independent intermediaries and that this power should be exercised so far as possible through self-regulation by the industry; that unsolicited 'cold-calling' for sales of investments should be prohibited by the Act except to the extent allowed by Regulations, which should permit it in respect of authorised life insurance or unit trusts but not otherwise; and that the ten-day 'cooling-off' period should be extended to cover sales of single-premium policies and of trust units, but that, in their case, the investor should be entitled to the return only the lesser of what he had paid or would have had to pay had he bought on the day of cancellation.

## PUBLIC ISSUES, TAKEOVERS AND INSIDER-DEALING

The Report deals with public issues of securities, takeovers and insider-dealing and recommends that the statutory provisions on these matters should be transferred, in a modernised form, from the Companies Acts to the Investor Protection Act. While no substantial amendments are recommended in respect of insider-dealing, a harmonised system is suggested for regulating invitations to the public whether on an issue or a takeover. The case for pre-vetting of prospectuses and for subsequent surveillance of the companies concerned and of any market-makers in the securities is stressed, particularly in the light of statistics which show that some 30% of filed prospectuses relate to securities which are not to be officially listed or dealt in on the Unlisted Securities Market (USM) a percentage which is likely to increase in the light of the Business Expansion Scheme. A system is recommended whereby supervision would be exercised by the Stock Exchange, in respect of listed or USM securities, and by the CSI and the Takeover Panel in respect of issues undertaken through members of self-regulatory agencies represented on the CSI.

## OFFENCES AND ENFORCEMENT

The Report recognises the problems of bringing about successful prosecutions. There is a recommendation that there should be a review of the method of trial and to the possible substitution of an ordinary jury with lay assessors with relevant experience. It also proposes that the co-ordination between the administrative, investigatory and prosecuting authorities be improved, to ensure that those who ought to be brought to trial have their cases disposed of more quickly.

## The Way Forward

As stated above, the purpose of this debate is to include the House of Commons in the consultation process that is currently being carried out by the Government, before it finally forms its own view. The current intention is that a White Paper should be produced by November 1984.

## INITIATIVES ON SELF-REGULATION

Initiatives have been taken to establish the appropriate structure and operation of self-regulatory groupings.

The Governor of the Bank of England, in a move designed to help in the management of the change of system, set up a Committee composed of leading City figures on 23rd May 1984 with terms of reference:

'to report within three months on the structure and operation of self-regulatory groupings that would most appropriately cover all types of securities activity (including investment management) together with commodity and financial futures' (Daily Telegraph, 24th May 1984).

The Governor has made it clear that any proposals must attract sufficient support to be capable of early implementation.

In order to keep in step with this initiative, Mr Alex Fletcher has invited the Life Insurance Industry to make proposals for a possible self-regulatory body to cover the selling of life insurance by intermediaries and other sales staff. Their proposals have been requested by the end of August.

## ENFORCEMENT

The Home Secretary announced on 8th November 1983 that a committee under the chairmanship of Lord Roskill had been established to examine the conduct of serious fraud trials. The committee will look at a number of issues, in particular whether trial by jury is appropriate in these cases, in view of their length and complexity.

Complementing this, the Chancellor of the Exchequer revealed on 3rd July 1984 the Government's intention to change the way in which cases of fraud are dealt with during investigation and pre-trial periods. A new, permanent Fraud Investigation Group will be set up in the Department of Public Prosecutions to deal with serious financial fraud cases. The new Department will come into existence on 1st January 1985.

### Conclusion

While the Government has come to no firm conclusions as to the final framework for the regulatory system, it is clear that an 'obtrusively legalistic framework' along the lines of the Securities Exchange Commission has been rejected. Mr Alex Fletcher has outlined one possible way forward. He said:

'the fewer self-regulatory agencies, the less justification for the intermediary body, therefore the more power can be devolved to the people in the front line, rather than a group of second guessers who aren't practitioners ... I just don't want a whole series of little clubs. That is not what the intention is. We are breaking the mould - let's really break it in that respect' (Guardian, 18th May 1984).

The independence of these agencies could be safeguarded by the inclusion on each council of a large proportion of outside members. The agencies' self-regulatory power would be conditional on an adherence to a strict code of conduct. The SRAs could have power to withdraw registration from companies failing to comply with the code. To make this effective Mr Fletcher has suggested that 'they will lay down rules for the members. If there are complaints, they will have power to go in and look at the books' (Financial Weekly, 8th June 1984).

Commenting specifically on the insurance industry, Mr Fletcher has suggested that there is a need for a single Ombudsman to deal with complaints over the whole industry. Mr Tebbit has summarised the requirements for the self-regulatory system:

'those rules must be robust enough to cope with variations in technique and practice but they must not permit foul play' (London, 26th June 1984).