



INSURANCE INSTITUTE OF LONDON

PRESIDENT'S LECTURE

**The Regulation of Financial Services in  
the United Kingdom**

Delivered by

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## THE REGULATION OF FINANCIAL SERVICES IN THE UNITED KINGDOM

I was originally billed to talk to you about 'Current Developments at The Stock Exchange'. The title was as broad as it was vague. Rather than spread thin paint over a broad canvas I have chosen to concentrate on the subject of regulation. I do this for a number of reasons. First, it is a very important subject. Good regulation is the basis of confidence. Second, it is not only The Stock Exchange and its constituents who face changes in the regulatory framework under which they work: reform is going to affect everyone concerned with advising on or selling a wide variety of investments, including people in your own industry. Third, it is necessary to dispel some of the myths which are growing up around the subject. And fourth, it is topical. It is almost as if the organisers of this President's lecture, when they invited me to speak a year ago on this particular evening, had advance warning of the publication of the Government's White Paper on investor protection a week ago. If this prescience was not a case of insider dealing, it surely reflects the collective foresight of your membership.

I shall examine this evening the way in which The Stock Exchange over the years has exercised its regulatory authority and the degree of success it has achieved in so doing. Then I shall discuss the main proposals which the White Paper puts forward for changing our system of financial regulation. Finally I shall attempt to emulate your prescience by trying to forecast the effect of these changes on the regulatory work of The Stock Exchange.

I shall attempt to avoid much of the jargon which increasingly surrounds this subject. Abstract nouns and phrases such as self-regulation, conflicts of interest, single or dual capacity and (most abstract of all) Chinese Walls, enable reformers and critics to sound very grand, very righteous and very learned. But they mean little outside the circle of practitioners who use them and they often obscure the real issues. Put at its simplest the purpose of regulation is to answer the questions which every investor is entitled to ask —

- will he receive detached advice?
- will he buy or sell at a fair price?
- how will he know that he has done so?
- will he be told what his agent, or the salesman from whom he is buying, is being paid?
- to whom can he complain and will he be treated fairly if he does?
- what are his legal rights?
- is he protected adequately against the default of his agent or of the salesman?

These are the questions that matter.

There are of course broader purposes which good regulation seeks to fulfil. First, our society has to be cohesive if we want to hold our place in the world and make some economic or social progress. We have to be confident that the laws, codes and conventions which govern any part of society, or any of our institutions, are fair. We want to know that ethical and moral standards are upheld, and that abuses, whether for political or commercial or personal reasons, are exposed and dealt with. If we do not do this, society will become generally immoral, political or financial greed will dictate the actions of the many rather than the very few, and our delicate system of political democracy will fall apart. Second, the link between trade and industry, on which we all depend for our standard of living, and the financial markets and institutions is very, very close. Britain's financial markets have, admittedly, succeeded through effort and skill and reputation in building on their domestic industrial foundation and become markets for the world. But they are nothing without domestic trade and industry. They exist primarily to serve trade and industry both in times of boom and in times of slump. Good regulation breeds confidence, attracts investors, and thus helps the liquidity of the markets for savings which industrial borrowers need. Bad regulation drives investors away and harms the interests of borrowers. Inefficient, bureaucratic, heavy-handed regulation obstructs efficiency and restricts the flow of savings into industry.

### **The Work of The Stock Exchange**

The Stock Exchange Council occupies a central position in the regulation of financial markets. It lays down rules and codes of behaviour, organises the complex business of surveillance to check that people are conforming to the rules and codes, and forces them to do so through an array of disciplinary powers reaching right up (or is it down?) to depriving a wrong-doer of his right to carry on his trade. All this The Stock Exchange Council does with hardly any statutory powers.

How did The Stock Exchange come to be such an important regulatory body, and what in essence are its regulatory powers?

There is nothing unusual about the principle of non-statutory regulation. In every country, even in that most legalistic of societies the USA, the stock exchanges carry some of the load of regulating their own markets and customers. Here, however, more of the load is borne by the Council of The Stock Exchange than in most other countries. Partly this is because we are older than most and have more experience. We have a more continuous tradition, unbroken by invasions, military defeats, political revolutions and collapses of the currency. Our present Rule Book is the direct descendant of the Rules and Regulations of 1812. Partly it is because in Britain we have so far avoided an excessively legalistic framework in our society from which we have won our constitution downwards. But mostly, I suspect, it is because the system has worked and has won respect. This success is acknowledged by the Government's White Paper: and the efficiency and durability of The Stock Exchange's authority is probably one of the chief reasons for the absence for decades of legislative reform.

The Stock Exchange regulates the behaviour of its members, their standards of conduct, both in their relationships with their customers and with other practitioners in the market, and their financial standing. It also regulates the behaviour of the buyers and sellers of securities who are bound to abide by the "Rules, regulations and usages of The Stock Exchange" — a rule which has a very ancient lineage and which covers not only the rules which dictate market practice but also the complex rules which ensure the successful settlement of the 20,000 or so transactions which are carried out every day.

The rules which govern transactions in the market are the expression of the concern of The Stock Exchange to prevent improper dealings in securities. In addition to policing its market rules the Council monitors market activity, looking for unusual price movements and carrying out investigations whenever price movements or complaints justify doing so. The power to summon members of The Stock Exchange gives the Council the speedy access it needs to the necessary information. Again there is nothing new here. The investigation into the major gilt-edged fraud in 1814, which was based on the alleged defeat of Napoleon, was almost a model for one of our present day enquiries. The essential difference between now and 1814 is that in 1814 police action followed immediately. Within a couple of months of the then Stock Exchange's enquiry, the miscreants had attended the Old Bailey and received their just rewards. The speed of The Stock Exchange's action is the same today as it was in 1814, but any court action today, even assuming the Department of Trade and Industry feels confident enough to institute action, is a matter of years rather than weeks. I shall return later to the deficiencies of State regulation.

The Council's most formal role is the control over the securities which are traded in the market. The requirements are set out in our Yellow Book. This sets out in considerable detail the information which companies must disclose to their shareholders when they first come to the market, when they want to make acquisitions or sales which materially add to or reduce their current business, when they announce profits, or dividends, and so on. It also lays down minimum standards of behaviour for sensitive activities, such as dealings by directors and employees in the securities of their own company, and obliges companies to conform to external codes such as the Takeover Code.

Only recently, as many of you will be aware, we have been obliged to amend our Yellow Book to bring it into line with our national obligations, as the Government perceives them, under the newly implemented European Listing directives. In implementing these directives, the Government was sufficiently confident in The Stock Exchange's experience and continuing ability to administer these regulations to designate The Stock Exchange as "competent authority". It was the natural choice, indeed the only choice, to take on this legal responsibility. Our only concern is that the Government may have been too zealous in the way in which it has implemented these directives, and that some of the flexibility of our former procedures, which has been so much a part of London's competitive advantage over other major financial centres, may have been lost. The Government was influenced perhaps by some over-vigorous legal advice, an unhappy and growing trend these days.

In summary, The Stock Exchange's regulatory restrictions (a word I use deliberately) have over the years enabled us to secure high standards of conduct and integrity on the part of members, member firms, employees and, to a very large extent, their customers. The rules protect investors and, above all, maintain public confidence in the ethical and financial integrity of the stock market. Investors who place their savings manager their savings for them, can know that all the questions which I asked on their behalf earlier can be answered positively.

## The Government's Proposals

That has not always been true of the whole investment industry. The creeping framework of an inefficient law has increasingly opened investors outside The Stock Exchange to unacceptable risks, as the failure of certain firms of licensed dealers in securities and commodity fund managers has demonstrated, sadly to the cost of investors who probably thought that they were better protected than they were. These misfortunes were the direct consequences of the failure of successive governments to bring the law up to date or to do the job of regulation which under the present law they should have been doing.

The State has let investors down and, in the ironic way in which these things occur, has by its inaction caused a dent in the high reputation of the City of London.

We have argued for many years that the law governing the sale of securities needs re-writing and that other investments need to be brought into the net. The Government's White Paper tries to grapple with these needs. The failures of the past have been recognised and the Government will cease to have a day-to-day role in the regulation and surveillance of investment activities. All sorts of investments will be covered and not just securities. Both reforms are long overdue.

Let us look at the aims of the White Paper. The Government says that its aims are to enhance efficiency, competitiveness, confidence and flexibility (Chapter 3.1). These aims are of course wholly laudable. It will not have escaped your attention that they are precisely the objectives that The Stock Exchange has pursued over the years and has largely achieved in its regulation of the central market in securities. The parallel with the way in which The Stock Exchange has regulated its affairs is even clearer when one studies the principles upon which the Government proposes to take action to achieve these objectives. I should like to read them out to you (Chapter 3.2):

1. *Market forces* provide the best means of ensuring that an industry meets the needs of its customers. If market forces are to operate properly it is essential that:
  - as much *information* as possible is disclosed about the investments and services on offer to the customer; and
  - the forces of *competition* are brought to bear on practitioners and their institutions.
2. The law should provide a *clearly understood set of general principles and rules* which facilitate:
  - raising capital in the United Kingdom;
  - investment and saving; and
  - buying and selling of investments.
3. *Prevention* is better than cure. The regulatory framework should make fraud less likely to occur in the first place.
4. Vigorous *enforcement* of a simplified, clear investment law is necessary to deter fraud and malpractice.
5. *Self-regulation* has a continuing and crucial contribution to make. It means commitment by practitioners to the maintenance of high standards as a matter of integrity and principle, not because they are imposed from outside. Regulation should encourage the commitment of individuals in the financial services industry to high standards. It is in the interests of both the industry and its customers that the opportunity for theft, fraud and deception, the buying and selling of securities and investment services should be minimised.
6. If the law and the regulatory system are to be clear and fair there must be so far as this is possible *equivalence of treatment* between products and service competing in the same market. The law should not create artificial distinctions.

These could almost be a description of the principles governing the operation of The Stock Exchange. And this can be no accident. In seeking to draw up a blueprint for the future regulation of the City as a whole it is natural that the Government would have to draw on the extensive experience of the best regulatory body already in existence.

The Government's proposals put forward a hierarchy of responsibility. At the top will be the Secretary of State for Trade and Industry. He will be responsible to Parliament and will have supreme authority to grant authorisations to carry on "investment business" in accordance with certain rules and principles. However, the Government recognises that it has neither the resources nor the political desire to undertake itself the detailed monitoring which would be necessary to decide whether or not authorisations could be granted. The Secretary of State therefore proposes to take the power to delegate his authority to the

second level of the hierarchy, namely the one or two supervisory bodies — the Securities and Investments Board for our industry, and the Marketing of Investments Board for yours. These bodies will have the responsibility for authorising, and withdrawing authorisation from, investment businesses, a function at present in the hands of the Department of Trade and Industry. They will also be allowed to "recognise" (and, presumably, withdraw recognition from) existing self regulatory organisations such as The Stock Exchange. The authority granted to these latter organisations, forming the third tier in the hierarchy, stems from the fact that their members will obtain authorisation to engage in "investment business" by virtue of their membership.

There will be a Tribunal, to which those whose authorisation to conduct "investment business" is turned down or withdrawn by one of the Supervisory Boards will be able to appeal.

Let us not waste time discussing whether or not this is a scheme for self-regulation. It is not. The subsidiary bodies in the hierarchy will continue to regulate themselves, but so they would in a fully statutory system of regulation, reaching always for better standards than the law imposes in order to secure a competitive advantage. The new bodies are virtually statutory commissions with unprecedented delegated powers.

Will it work? Before trying to answer that question I would like to look at the relationships between the actors who will occupy the stage.

First, the relationship between the Secretary of State and his department on the one hand, and the Supervisory Bodies on the other. In present circumstances, the relationship between Government, the Bank and The Stock Exchange (who meet together regularly in The Stock Exchange Monitoring Group) is, in relation to the securities industry at least, very much a relationship of equals, with the Government perhaps filling the classic role of the Prime Minister in Cabinet of being *primus inter pares*. Under the White Paper proposals the Supervisory Boards would quite clearly be subservient to Government because:-

- their constitutions will be governed by the principles set out in the White Paper;
- the chairmen and boards will be appointed by the Secretary of State, in one case with the agreement of the Governor and in the other in consultation with "sectors of the financial services industry involved";
- the bodies will be required by statute to report annually to the Secretary of State who will lay their reports before Parliament;
- the bodies will be subject to the provisions of competition law;
- the decisions of the bodies will ultimately be referable to the independent Tribunal which will be appointed by the Secretary of State and financed by Government funds.

The fact that the bodies will be able to make rules having the force of law will virtually guarantee that Parliament will insist that the subservience of these Boards to the Secretary of State is beyond doubt.

Thus to all intents and purposes the Boards will be servants of the Government paid for by practitioners. This will have to be accepted.

Second, the relationship between the Supervisory Boards and the self-regulatory organisations such as The Stock Exchange. The Supervisory Boards will only grant "recognition" to an existing self-regulatory organisation if they are satisfied that it has and maintains "the ability to regulate the admission and conduct of its members and that its rules provide a standard at least equivalent to those of the Board's itself".

Clearly, large, sophisticated and well-regulated bodies such as The Stock Exchange will gain surveillance function to that of The Stock Exchange. And it is difficult to envisage the Supervisory Board, left in the hands of The Stock Exchange, withdrawing it. In practice, a great deal of practical autonomy will be granted recognition, withdrawing it. In practice, a great deal of practical autonomy will be granted to do otherwise would be inefficient and expensive.

Third, the relationship between the Supervisory Boards and the appeals Tribunal. This is in many ways the most sensitive and difficult relationship to predict. The Secretary of State alone will have the power to decide who comprises the Tribunal. It is vital that he makes the right choice because the functioning of the Tribunal could undermine the authority of the Supervisory Boards. A great deal of thought needs to be given to this delicate relationship before the enactment of legislation.

Fourth, the relationship between the Securities Board and that other successful example of self-regulation, the Panel on Takeovers and Mergers. The Government's paper is silent on this. The position of the Panel, of which I am a member, needs to be clarified. There is a risk that it would lose its effectiveness if it were subsumed into a statutory framework.

And last, the relationship between the two proposed Boards themselves. There seems to me to be little point in having two Boards since the handling of different types of investment are tending to converge within firms both inside and outside The Stock Exchange and most businesses would have to register with both authorities. There may be a practical difficulty to begin with in agreeing the details of the regulation of life assurance and unit trusts, and this may need temporary arrangements before legislation is enacted. But I expect the two Boards to converge by then and see advantage in them doing so.

Each of these relationships poses problems which will have to be solved. But there is time to solve them, and I am assured that the provisions of the White Paper are not carved on tablets of stone.

Having said this, I cannot of course say with any certainty whether this structure will work, especially so far in advance of the legislation which will bring it into being.

Success will depend on at least five requirements. First, the new structure must maintain flexibility both in the application of rules and its procedures so that Britain can remain a competitive international capital market. Second, the detailed rules and procedures, which will presumably be devised before legislation obliges individual firms to apply for registration, must set a high standard and not compromise for the sake of either accommodating every practitioner or appeasing vested interests. Third, the members of the Boards and their staff must be of high calibre and drawn largely from practitioners who understand the task. Fourth, the method of financing the Boards must be fair and not tax again practitioners who are already well regulated or investors who are already well protected. Fifth, the directly registered practitioners, many of whom have no community of interest with each other, must be willing to conform to requirements promptly and without litigation.

If the structure does not work, there will be no alternative but to set up a statutory commission. Under this government the Department of Trade will have neither the political backing nor the resources to enable it to undertake the responsibility itself.

A statutory commission is likely anyway to be our ultimate destination, but to set one up in the immediate future would be a worse solution. It would introduce immediately into regulation a legalistic dimension which could do harm to Britain's competitiveness, and it would be unhappily devised without any of the evolutionary experience which the present proposals offer.

### Effect of the Stock Exchange

I promised at the outset to attempt to emulate the prescience of your organisers by forecasting the effect all these changes will have upon the operations of The Stock Exchange. I hope that what I have said this evening will have enabled you to see through this disingenuous promise. It is not difficult to predict that in the new "practitioner-based" system of regulation that is being proposed by the Government, there will not only be a place for The Stock Exchange, but that its position will be in most respects identical to the position it occupies today.

I frequently see the comment that The Stock Exchange is being "de-regulated". I also read that the new framework of regulation is needed particularly because of changes in The Stock Exchange. Both propositions are untrue. "De-regulation" is another of those abstract buzz-words which obscure thought. The Stock Exchange will abolish two sets of rules — the rules obliging brokers to charge a minimum fixed commission and the rules obliging the separation for the most part of the activities of brokers and jobbers. In place of these two sets of rules The Stock Exchange will be writing a lot more, to ensure that standards continue at the highest level and that investors who invest their money through The Stock Exchange continue to enjoy the very high level of protection which they have enjoyed in the past.

Nor do the changes which we face within The Stock Exchange need a new Board to supervise them. We will ensure that new firms who come into our market conform to our rules and to our standards. In short The Stock Exchange, which will remain the largest most experienced regulatory body in the City, will continue to exercise the long and successful tradition of regulation, surveillance and enforcement for which it is well known. Why anyone should suppose otherwise, I do not know. It can only be due either to malice or to ignorance. Indeed, if anything, the changes will extend The Stock Exchange's work and thus solve part of the present problem, in that firms who have not in the past been directly regulated by it will be joining its ranks.

The gain to be made from the Government's proposals is not inside The Stock Exchange, but outside it. If the proposals are successfully implemented there is a hope that in two years' time there will be some improvement in the lot of investors who choose not to use a Stock Exchange firm. This is after all the chief aim of the proposals. The Government has set out to improve the regulation of dealers in securities outside The Stock Exchange and to bring into the net investment products which are at present covered by no regulation.

I hope the aims will succeed.