Regulation in financial markets

In a speech on the theme of the Bank and self-regulation[1] Mr D A Walker, an Executive Director of the Bank, remarks on the benefits London has enjoyed as a competitive financial centre from the light-handed regulatory regime adopted. Restriction, disclosure and integrity are essential elements in any regulatory arrangement—he considers the mix of these and the circumstances in which self-regulation rather than state regulation is most appropriate. Mr Walker also discusses the role of the Council for the Securities Industry.

The impact of regulation on markets

Regulation in the financial area has often grown from arrangements that cover dealings among traders in a particular market, but what mainly concerns us here is protection of the interest of the client and of investors generally, and most of our attention focuses on how that aim, appropriately stated, can best be achieved. This is a major concern of the Bank of England, but it is matched by concerns about possibilities for wealth creation in our financial sector as well as enlargement of the array of options available to the customer. It is important to keep these parallel concerns in mind because regulation is usually asymmetrical in its effects. It is patently a means of restriction and limitation, but it is rarely a means of stimulating new activity, at any rate in a controlled way. This asymmetry assumes greater importance in the financial area when many other forms of economic activity have been in decline; the success of our financial sector depends as much, if not more, on our wits and skill as on the strength of its capital base; and competition from elsewhere in the world in the provision of a widening array of financial services has probably never been more intense.

Some of our City markets, for example those for syndicated credits and eurobonds, have benefited significantly over the years from restrictions applied in the United States. Although many of these have now been dismantled, their effect has continued; a market advantage, once seized and consolidated, tends to develop an independence from its original cause and may become increasingly difficult to dislodge. But while London has in this way benefited from regulation elsewhere, there is no cause for complacency. We need to keep in mind that our own restrictions inevitably have an effect on the pattern of business on which they are imposed.

Generally, if one looks at the performance of British banking, money broking, insurance and commodities business in world markets over the past two decades, part of the overall success that has been achieved is clearly attributable to the relatively light regulatory touch that has been applied; inventiveness and enterprise was not impaired. This underlines that we must be continually sensitive and alert to steer clear of regulation that is so comprehensive that nothing can be done, so to speak, without planning permission. Such restrictiveness is no doubt needed in respect of land use. But the application of comparable restriction in the financial area is a way of ensuring that some potentially promising ideas do not leave the drawing board.

Regulation has an opportunity cost, and excessive or heavy-handed regulation, by whomsoever administered, can be distorting and destructive in its effects. Equally, in the concern for client protection there may sometimes be a danger of making the best the enemy of the good or, through a misplaced protectiveness, delaying change which may be much in the interest of clients. This is far from saying that regulation and successful enterprise are inevitably in conflict. The trick—and this is perhaps a particular concern for a central banker—is to find the balance between the two which ensures that they are as far as possible complementary and mutually supportive. It needs no emphasis that, if the clients of UK financial houses had thought that their interests were inadequately protected, then London would not have become the world financial centre that it is. It cannot hope to retain and develop that position unless there is confidence that its clients are properly protected.

Elements of regulatory arrangements

With this perspective in mind, the next step is to consider what regulation is most likely to promote the complementarity that I have described. The question is not one of state regulation versus self-regulation but of what is the most appropriate mix of the three elements—restriction, disclosure and integrity—which in some combination provide the basis for any regulatory arrangement.

Restriction

Taking these in turn, there are circumstances in which the restrictive element in regulation would generally be regarded as essential. Such restrictive regulation may be directly by government, as with the licensed dealers' rules or the solvency margins for insurance companies, through

(1) At a conference organised by the Council for the Securities Industry and the Institute of Chartered Accountants in England and Wales, on 25 October.

self-regulation by a statutory body, as in the case of Lloyd's, or by a non-statutory body such as the Take-over Panel. But in all cases there is a more or less general acceptance of standards that need to be observed in the common interest. Another example is the substantial acquisitions rules, where an important part of the protection provided to the investor flows from the timing delays that are built in before a potential bidder can increase his stake. Disclosure cannot, after all, help those to whom it is not practicable to make the relevant information available in a sufficiently timely way.

Disclosure

Disclosure provisions constitute some sort of mid-point between detailed restrictions with respect to balance sheets, or on the way in which business is or is not to be done, and an extreme of *caveat emptor* in which the client is afforded no protection beyond what he can secure for himself on his own initiative. Disclosure is most appropriate where the client and others involved are capable of assessing what is disclosed and of relating their decisions to it, and where those responsible for the business in question conduct their affairs in the knowledge that they will be disclosed. Restrictive provisions give the client assurance that particular types of transaction cannot properly be engaged in; the agency rules that constitute single capacity at the Stock Exchange are a topical example. In the absence of such restriction, fuller disclosure provisions would be an important necessary element in assuring similar client protection.

While restrictive rules may protect the client in a very direct way, they may also limit freedom of choice; in contrast, disclosure provisions may be a means of preserving or enhancing it—possibly permitting an option involving lower cost. This is of growing importance as the revolution in information technology increases the assimilability and speed of information that can be made available to the individual.

Integrity

Integrity on the part of practitioners is a key ingredient in any system of regulation. Without it, not even the most restrictive system can work satisfactorily. But its role is greatest where there is need for individual or corporate decision in an area where there are no established rules—perhaps because the need for them has not arisen hitherto—or in a changing situation where market developments are well ahead of the regulator. Integrity has a special importance in evolving situations, so to speak at the frontier, and it may be both natural and efficient that as old frontiers are passed different methods of regulating particular areas of activity become more appropriate. This is to say little more than that regulatory methods should be allowed to evolve and that techniques that are appropriate for a particular business at one phase in its evolution may become less appropriate as it develops and, perhaps, newcomers enter an expanding market. Where matters that were formerly for determination solely on the basis of individual decision lead to the establishment of generally accepted conventions there is merit in enshrining these in specific rules. The insider trading provisions are a good example, now in the companies legislation; the take-over code is an example in the self-regulatory area.

But unlike restrictions and disclosure provisions which have to be defined in specific terms, integrity is patently not a control variable. This reflects that integrity has a life of its own, stemming from some amalgam of pride in a particular business ethic, enlightened self-interest and what might be termed common decency, which cannot be switched on or off or fine-tuned by the fiat of the regulator. This does not mean, however, that the quality and quantum of integrity that is brought to bear in business situations in general is uninfluenced by the broad regulatory arrangements that are in place. For the potential importance of integrity in any situation tends to vary inversely with the weight placed on specific restrictions or disclosure provisions. There is a danger of crowding out in the sense that the more comprehensive the framework of rules and the regulatory structure within which they operate the less the attention paid to the spirit and the more to the letter. The spirit of the matter then acquires a diminished meaning as mere compliance with restriction or disclosure provisions comes to be seen as sufficient. This nourishes the sense that anything can be done which does not break the rules that have been laid down. Integrity remains but, by virtue of its lessened use, it may be at some risk of atrophy like a muscle that is underused and is, in consequence, less dependable when an unfamiliar stress is placed upon it. The analogy seems precisely relevant to the prospect of increasing overlaps and potential conflict situations in the financial service area. If provisions of a restrictive kind, or for disclosure, are not to obstruct development of new areas of business a heavy continuing reliance will need to be placed on the integrity of practitioners.

The balance between state and self-regulation

This leads to a series of more severely practical propositions.

The first is that self-regulation, placing a good deal of weight on the integrity of the practitioner, seems bound to continue to play a significant role in regulation. The main reason is that the actual or prospective pace of change in many areas, partly reflecting new technology but also competitive pressures elsewhere, is such that no other system of regulation is likely to be able to cope. One difficulty for self-regulation, however, is that it—or the integrity on which it rests—is much less visible than specific restriction or disclosure provisions. There are understandable concerns to raise its profile, to make it more manifest and apparently better organised, and to delineate more narrowly the areas or the authority left to self-regulation. But there is a delicate balance to be struck here. At its best, self-regulation is cost-effective, and costs the taxpayer nothing. But the resource commitment for those involved in it can nonetheless be large, and they will be unready to remain committed if their freedom of action over and above minimum standards specified by government or other authorities is unduly circumscribed.

The self-regulator must be free to specify and enforce his own evolving high standards, and interference with this capability, save through provision for judicial review, risks upsetting the whole basis on which such regulation is undertaken. If the commitment of those engaged in self-regulation is weakened, the risk is then that regulation overall would become less capable of assuring high standards, less flexible and a larger burden on the taxpayer.

The second practical proposition is the obverse of the first. Although interference can undermine self-regulation, there is, or should be, a complementarity between self-regulation and the role of the state, each with its role to play. Self-regulation is at its best in areas where like-minded people in similar lines of business share a common interest in achieving high standards. It cannot be forced as a discipline on those who neither wish to participate in a self-regulatory grouping nor perhaps would be acceptable to other members of it. This points to the continuing need for individual licensing procedures as under the prevention of fraud legislation, and there is probably general agreement that the relevant provisions in this legislation need to be strengthened in a number of respects. But it also underlines the importance of appropriate regulatory action by government in areas that the self-regulator is unable to cover—for there tends to be a presumption that anything that goes awry in an area not covered by some form of government regulation marks a failure of self-regulation.

Beyond this, while self-regulatory bodies can be very effective in bringing sanctions to bear on one of their members who steps out of line, their stiffest sanction is expulsion from membership. Though this may deprive someone of his ability to earn his livelihood in future, it may be an inadequate and inappropriate penalty for perpetration of an act of fraud. This is a matter for the law and for the courts, and it is important for those who seek voluntarily to maintain high standards that those who transgress even minimum standards laid down in statute should be appropriately brought to book. It follows that all those who are concerned to maintain and strengthen the role of self-regulation must welcome action taken to improve the processes of investigation, prosecution and sentencing in cases of fraud.

Role of the Council for the Securities Industry

Third, I turn to the role of the Council for the Securities Industry (CSI). The twin concerns that underlay its establishment in 1978 were that the highest ethical standards should be maintained in the securities industry, affording clients a degree of protection both prior to and over and above any right of recourse to the law and the courts; and that, in many areas, the best way of achieving such high standards continuously, without impairing new business development, was for practitioners themselves to play a large part in the regulatory process. A good deal of misunderstanding has stemmed from the view that the CSI is itself, or should be, involved in detailed regulation, but this was not the intention. It is rather a supervisory and advisory body whose authority derives from the breadth of its representation of market users and practitioners and their commitment to it, together with its lay members, and the quality of its chief executive and full-time staff. Where the CSI believes that initiative is called for in the self-regulatory area, its job is to try to inspire those concerned to take appropriate action. Part of the task is one of proselytisation and enlightenment of self-interest in appropriate self-regulation. Where it identifies the need for some other form of response, for example where there is a gap in the regulatory structure that cannot be filled by self-regulation, the CSI is constituted to advise government and the Bank and particularly well placed to do so. Given its provenance, such advice will never be lightly disregarded.

But the task of promoting better self-regulation calls for a delicate balance. On the one hand there is a concern to make self-regulation more orderly, comprehensive and manifest. On the other hand there are resistances to interference or attempts to homogenise the distinctive approaches of individual self-regulatory groupings that may have worked well hitherto. Both concerns are understandable, and can probably only be reconciled by readiness on the part of the CSI to stand back in general from the business of detailed rule-making, concentrating on broad guidelines and codes, save in the Take-over Panel area and, exceptionally, in one or two others. But such self-denying ordinance needs to be matched by a readiness on the part of market practitioners to accommodate as far as possible to broad guidance from the CSI and, where necessary, to institute within their own groupings specific provisions which give effect to such guidance. Hardly surprisingly, this delicate balancing act has not invariably been achieved in the first few years of the life of the CSI. But there has been a major learning process for all those involved in its activity and the CSI is now better placed than it has ever been to play and develop its role. Given current and prospective securities market developments, the need for the CSI to play a major role at the heart of the self-regulatory structure is greater than ever before.

Conclusion

The task then is to achieve satisfactory regulation while not cramping the initiative and adaptation that will strengthen our securities industry. This complementarity is most likely to be achieved if our regulatory arrangements evolve in a way that continues to leave a substantial responsibility with those who are directly and currently involved as market practitioners.