The future of the securities market

The **Governor** *reviews*[1] *developments in the securities market that have followed the announcement last July by the Secretary of State for Trade and Industry of an agreement on the basis of which the Stock Exchange might be removed from the ambit of the Restrictive Practices Court.*

- *'We in the Bank . . . remain quite clear that our wish is to see a stock exchange which offers maximum liquidity and investor protection; and which plays its full part in a vigorous, competitive UK securities industry, capable of gaining a significantly larger share of the total world market.'*
- *'It seems to me cause for satisfaction that many of the associations which are being formed represent British groupings backed by substantial capital resources and ready to take up the competitive challenge.' But . . . 'the whole question of actual and prospective conflicts of interest now needs to be examined in some depth.'*
- *'There are many uncertainties about a practicable self-regulatory structure for the future and time is running short.' . . . 'Because I believe that the time is now ripe to move ahead from discussion on concepts to specific action, I have decided to constitute an advisory group of senior City figures and practitioners to advise me as a matter of urgency on the structure and operation of self-regulatory groupings which they would feel confident could in practice be formed in the near future.'*

On 27 July last year, the Secretary of State for Trade and Industry announced in the House of Commons an agreement on the basis of which the Stock Exchange might be removed from the ambit of the Restrictive Practices Court. On 12 April this year, the Stock Exchange published a discussion document outlining possible new trading systems and other changes in its rules, all of which flowed from the key element in the agreement with the Secretary of State, namely the abolition of minimum commissions. To the future historian, these two events will doubtless seem as one and the interval between them of no great account. You and I know better. There can be few, if any, comparably short periods in the history of the Stock Exchange, perhaps even of the whole financial services industry in this country, which have witnessed such rapid development of thinking and the inauguration of a process of such far reaching structural change.

Few of us who were involved in the discussions leading up to the Secretary of State's announcement were in any doubt about the extent and importance of the changes that would eventually result from the agreement reached. At that time, we recognised the possibility that events might snowball, in the sense that there might be a rush by non-member institutions to seek participations in members in anticipation of changes assumed to be inevitable. But it was possible to hope that we might be able to edge towards negotiated commissions in a way which would enable us to observe the effects at each stage. Once the proposal was open to public debate, however, it was clear that this was not going to be practicable. It was then that the term 'big bang' entered the vocabulary of the Stock Exchange.

The prospective size of the bang also increased as voices in favour of the case for introducing a new trading system, at the same time as the move to negotiated commissions, began to gain strength. There remained, however, a body of opinion which held that the jobbing system could be preserved and which by implication rejected the inevitability of the link argument. Some of the proponents of that view added a qualification—the jobbing system could be preserved as the exclusive dealing system, despite the advent of negotiated commissions, provided the Bank of England were formally to state that it wished the Stock Exchange to retain it. This we believed we could not and should not do—for two reasons. In the first place, it would seem inappropriate to attempt to replace a judgement of the Restrictive Practices Court by an edict from the Bank of England. And, in the second place, we were not certain that it was right to want to preserve the jobbing system as the only trading system, at all costs or in all circumstances. Not that we were then, or are now, unalive to its manifest virtues. It is certainly arguable that

(1) In a speech at the Stock Exchange Northern Unit conference in Liverpool, on 23 May.

the jobbing system and separation of capacity provide the best mechanism for a domestic securities market that can be devised: liquidity is assured, the investor is protected and the whole possesses an elegance not to be found in any alternative.

However, it is not open to us simply to choose the best market system for our domestic purposes, without regard to the realities of the outside world. These realities are—and have been for some time—intruding most insistently. The inescapable fact is that securities trading is now an international activity and if we in this country wish to play any significant role in the world securities market, we must be equipped to compete. There must, however, be doubts over our ability fully to meet international competition if our central market for securities conducts its trading in a way which is unique to this country and which thereby may handicap its members in regard to its non-member competitors at home and overseas. It is rather like sending the principal players in the UK team onto the international playing field bound by the rules of rugby league when the rest of the team and all the opposition are in fact playing association football. And we must not allow ourselves to be misled into thinking that it is possible to play rugby at home and soccer away, since important parts of what we might regard as the home pitch are, in fact, now part of the international playing field and, indeed, it is in our interest that it should be so.

In my estimation, the mounting pressure of international competition would by itself eventually have brought about the demise of the jobbing system as the exclusive or principal trading system of the Stock Exchange, even if there had been no Restrictive Practices Court case and hence no agreement with government to abolish minimum commissions. Be that as it may, as the consultative document makes clear, the Council of the Stock Exchange has concluded that the dealing system as it now exists will not be sustainable once commissions are negotiable.

Requirements for a new trading system

If we in the Bank were unwilling to attempt artificially to preserve the jobbing system by edict, it was not because we wanted to impose a particular alternative trading system. On the contrary, it seemed to us essential that any new system should be proposed by the market itself and should emerge from a consensus among members, reached in the light of a full debate, in which all interested parties would participate.

The discussion document now represents the focus of that debate but, of course, a ferment of ideas and a great upsurge of discussion started the moment the Secretary of State made his announcement in July. One of the great advantages of removing the Stock Exchange from the Restrictive Practices Court was that new ideas, all shades of opinion, heresies even, could then be openly discussed without fear of prejudicing the case for the defence.

We in the Bank came to that debate armed with no blueprints but with some clear broad objectives, shared with government. We were at the outset, and have since remained, quite clear that our wish is to see a stock exchange which offers maximum liquidity and investor protection; and which plays its full part in a vigorous, competitive UK securities industry, capable of gaining a significantly larger share of the total world market. These objectives were of course shared not only by government but also by the Stock Exchange itself.

In adopting such general objectives, we were consciously underlining that our concern was with ends rather than with means. Provided liquidity and investor protection were secured, we were open minded about the precise structure of the trading system. Naturally, we had particular ideas we wanted to discuss but in a spirit of learning rather than in an attempt to make converts to some preconceived master plan. To this end, we have had extensive discussions with a large cross-section of member firms individually and in various committees and I know from my colleagues how patiently and helpfully member firms have responded to this persistent catechism. In return, we have endeavoured to explain our own attitudes and the way in which our thinking was developing, much as I am doing now. From our point of view, it has been an invaluable dialogue.

When we first embarked on this programme of intensive discussion, it was possible to believe that, as it proceeded, we would be able to identify with growing confidence the particular characteristics of a market system necessary to achieve the objectives which I have mentioned. We certainly now have a clear idea about the nature of the future gilt market and I will come to that in a moment. The equity market, however, demands much more difficult judgements. We are convinced that a central market, that is to say one in which all orders are able to interact, offers the maximum degree of liquidity. We also think that ability to deal continuously in reasonable size is an important attribute of liquidity. That suggests the need for committed market makers ready to make continuous prices and trade in foul weather as well as fair.

But what is to compensate those who undertake the hazards of that role? One possibility is a system of order exposure, which allows the market maker to see the total order flow, rather as the jobber does now. But there is an understandable reluctance in a market which has abandoned obligatory single capacity to see arrangements which compel customer business to be revealed to competitors. As regards investor protection, we are convinced that an important contribution will have to come from arrangements for disclosure. This could, and I believe in time inevitably will, involve contemporaneous publication of the size of deals and the prices at which they have been transacted. This is said, however, to make the flesh of some prospective market makers creep (if that is an appropriate expression to use of men of such undoubted mettle). Instant transparency, it is argued, will make it possible to infer the shape of

the market maker's book and, as a consequence, no one will be prepared to commit himself to making continuous prices.

American experience suggests that these fears may not be wholly justified, but, if they are, we have the paradoxical situation that what protects the investor in one way does him a disservice in another. And it is not only the interests of the investor which are damaged by an impairment in liquidity. The other side of that coin, and every bit as important, is that the interests of the company coming to the market for money are also damaged, since, if there is no certainty of a liquid aftermarket, the cost of raising capital will be greater.

None of this means that liquidity and investor protection are necessarily inconsistent objectives. A more liquid market is likely to be a more competitive market and competition itself provides significant protection to the investor. These are, nevertheless, difficult matters for judgement and it is not for me to anticipate the outcome now. What is important is that the right questions should be squarely addressed and I am confident that it is what the Stock Exchange Council, with its London, country and lay members, is now doing. The debate is a very important one, for members of the present market, for those who will become more significant players in the future and for the nation as a whole. This being so, it seems to me both natural and desirable that the debate should be a vigorous one. We in the Bank remain open-minded about the future trading system in the equity market, or perhaps I should say 'systems', since we recognise the possibility that two or more may need to coexist. We shall, of course, subject the proposals which ultimately emerge to critical scrutiny, as will the Government, but we recognise that the system that is arrived at must be one which the members accept as technically workable and as capable of offering them the opportunity of operating profitably.

The gilt-edged market

Let me now turn to the gilt-edged market. Our general objectives in this area are no different from what they are in the rest of the market. We wish to see maximum liquidity and suitable investor protection and we think that the new structure outlined in the discussion document provides an appropriate basis for achieving our objectives.

With the Stock Exchange, we will now develop the structural features of such a market in more detail, including our criteria for the commitments we shall expect from the market makers with whom we shall conduct our own operations. These will certainly include a commitment to making continuous two-way prices and a capital base appropriate to the intended scale of operations in the gilt-edged market. We would expect to monitor compliance with such conditions and to exercise close and continuous supervision over the activities and financial condition of the market makers.

The number both of member firms and of institutions which are not yet members which have expressed serious interest in participating in a restructured gilt-edged market on this basis suggests that ample liquidity should be generated. Moreover, the prospective level of competition promises a high level of market efficiency. In our discussions with prospective market practitioners, we are paying particular regard to these features. But we shall also make sure that the needs of the small investor in gilts continue to be properly catered for and that adequate arrangements are in place to assure investor protection.

It is implicit in this model for the gilt-edged market that some potential market makers which are not at present members of the Stock Exchange should be able to participate. At the same time, we want to see the gilt-edged market retained within the administrative and regulatory framework of the Stock Exchange, rather than conducted outside it, though I do not mean by this that dealing would necessarily have to take place only on the floor of the Exchange. We therefore welcome the consideration which the Council proposes to give to the way in which outside interests can be brought into the Stock Exchange. Indeed, I cannot see that there is any sensible alternative policy. It is not possible to guarantee the Stock Exchange a monopoly of dealing in its listed securities and, if the market is not to be fragmented, the competing outside institutions, both British and foreign, must somehow be brought in. Even so, the Stock Exchange will remain the central market, as we would wish it to be, only if it offers the best prices and the best service. I have no doubts about its capacity to do so.

The pace of change

Hardly surprisingly, some outside observers, and perhaps even more within the Stock Exchange, have expressed unease about the pace of change. They have a sense of decisions being taken overhastily and of the market being rushed into new situations before anybody is ready to deal with them. I well understand that feeling, though I do not altogether share it. It seems to me that none of the changes within the Stock Exchange that have been implemented so far could be described as either excessive or insufficiently considered. The two most important have been the addition of lay members to the Council—and even the most hardened opponent of that move would, I hope, concede that it has been beneficial—and the decision to allow the formation of international dealers. This latter decision is, I understand, the product of ideas which have in fact been debated for more than a decade. What has perhaps contributed most of all to the impression of constant change is the number of participations taken in various member firms by outside institutions. Most of these have been announced since the Stock Exchange's agreement with the Government, although the rules which made them possible were in place long before.

It seems to me cause for satisfaction that many of the associations which are being formed represent British groupings backed by substantial capital resources and

ready to take up the competitive challenge. We in the Bank can certainly claim to have contributed to a climate of opinion favourable to the development of proposals for groupings of this sort but the specific deals that have been announced represent the considered judgement of the participants themselves as to their mutual commercial advantage. They seem to me to represent a resounding vote of confidence in the future of the Stock Exchange, in particular on the part of people at present outside it.

The prospective appearance on the scene of these and other powerful players has given rise to anxiety that the Stock Exchange of the future might consist only of a few very large member firms, sharing all available business between themselves. This seems to me an extremely unlikely outcome. The securities industry in this country has always been characterised by a wide diversity of needs and interests, many of which have become the specialisations of smaller member firms. I do not believe that this diversity will be any the less in future or that large corporate securities houses will invariably be able, or will indeed seek, to satisfy specialised requirements with the same success as the existing smaller firms. The provincial and country members have a particular strength in this respect, in that they know far better how to service the needs of the local communities in which they operate than any outsider can ever hope to do. They are also particularly well placed to take advantage of any return of the smaller private investor to the Stock Exchange, about which I seem to detect a certain quiet optimism among a number of member firms. The same, of course, is true of the smaller London firms who serve the needs of the private investor. Most important, it cannot be too strongly emphasised that, if the Stock Exchange adopts a form of dual capacity, it will be permissive and not compulsory. There will, I am sure, always be a need for the member firm which does agency business only and the opportunity that goes with this may be still greater for many individual firms in future.

The feeling that everything may be moving too rapidly is doubtless fostered also by growing awareness of the many complex issues which need to be resolved before we reach what might be regarded as a steady state. There are first the questions of trading structure and membership that I have already discussed. Until firm and fairly detailed decisions are taken on these matters, only limited progress can be made in providing the appropriate technological infrastructure, without which an efficient trading system will not be possible. Indeed, such is the importance of technology that it is the lead time for designing and testing new systems that is the principal determinant of the timetable for prospective change. That alone prevents a headlong rush into unfamiliar situations.

Regulation and investor protection

In addition to these structural and technological questions, there is a range of regulatory matters which are certainly of direct concern to the Stock Exchange but which do not lie totally within its competence to resolve. I have principally in mind, of course, the conflicts of interest to which reference is made in the discussion document and about which I have also spoken recently. It will not be possible to identify precisely every circumstance in which abuse can arise from conflicts of interest until the new trading system has been determined. The principal dangers, however, become evident the moment one postulates the formation of financial groups which, in one manifestation or another, will be able to act as issuing house, market maker, investment manager and broker. These conflicts of interest are of course not new. Some participants in the eurobond market are already confronted with them. But in the market for most domestic securities, such conflicts have hitherto either been avoided altogether, or have existed in much more limited form. It is clear that the whole question of actual and prospective conflicts of interest now needs to be examined in some depth. Whatever solutions are reached, it is essential that the means by which abuse is to be avoided must be made public and must conform to an agreed minimum standard.

Where conflicts of interest occur within a stock exchange member firm, ultimate responsibility for ensuring that the client is suitably protected must rest with the Stock Exchange. Various forms of exposure and disclosure, about which I have already spoken in the context of the trading structure, constitute some of the possible means of providing that protection. Others involve different degrees of separation of the activities which give rise to conflicts of interest. The obvious case where some sort of separation is necessary is between principal and agent activities in a broker dealer. The circumstances in which the broking arm can place agency business with the arm which deals as principal must be clearly defined. Doubtless, an appropriate mixture of all three, that is to say exposure, disclosure and separation, will provide the eventual solution to conflicts of interest within member firms. Whatever is decided cannot help but affect the fundamental design characteristics of the new trading system.

Means of dealing with conflicts of interest which involve discretionary investment management seem to me to depend less on arrangements affecting the basic trading mechanisms and I note the strength of the view reported in the discussion document that discretionary fund management should be seen to be entirely independent of any principal dealing functions in the future. Regulation inevitably becomes more difficult, for the dual capacity firm which also undertakes investment management is effectively operating in triple capacity. I am quite clear in my own mind that, if stock exchange members are to be allowed to be both principals and investment managers within the same firm, the most convincing of Chinese walls must be erected between the two functions. Professor Gower, as you may know, is apt to say that there are often grapevines trailing over Chinese walls. Be that as it may, I think it unlikely that we shall be able to devise a regulatory structure which does not include as a prominent feature arrangements for separating various

activities within institutions or groups. It will therefore be up to the Stock Exchange, or rather the financial services industry as a whole, to convince the public that Chinese walls do make a significant contribution to client protection. If necessary, arrangements will have to be instituted to make sure that both sides of the wall are policed. Beyond this, and whatever the precise trading system, the Stock Exchange will no doubt continue to protect the investor in many other ways, ranging from the imposition of listing requirements to the provision of compensation arrangements, all of which will remain of great importance.

The capacity of the Stock Exchange effectively to regulate its members will I am sure be greater if, as is proposed in the discussion document, member firms are required to be constituted as separate entities, even when wholly owned by non-members. But, of course, such a requirement cannot by itself solve all regulatory problems. How should the Stock Exchange deal with conflicts of interest which arise between two firms of a group, one of which is a Stock Exchange member and the other not? The answer might vary with the precise circumstances. Where there are only two firms in a group, one of which is a broker dealer and the other a non-member investment management company, the answer might be relatively straightforward. It would be bound to be less so, if the group were a highly diversified financial services group with a worldwide network and the Stock Exchange member firm were only a minor component part.

Even here, the Stock Exchange can doubtless reasonably hope to exercise some influence over the non-member parent and the non-member siblings, at least with respect to their dealings with the stock exchange member. But it would be unreasonable to suppose that the Stock Exchange could undertake sole responsibility for the regulation of all conflicts of interest, where it had direct jurisdiction over only one end. And, of course, potential conflicts of interest extend into many parts of the financial services industry where there may be no stock exchange involvement at all. Emerging conflicts of interest therefore represent a problem for the financial services sector as a whole and a challenge for the entire regulatory edifice. I would now like to turn to that wider scene.

Self-regulation

There are many uncertainties about a practicable self-regulatory structure for the future and time is running short. I know that some of the potential conflicts of interest will not become actual until the Stock Exchange changes its rules on the ownership of member firms and, as I have said, some of the obvious conflicts will necessarily be dealt with by the trading structure. Others may fall comfortably within the regulatory competence of the Stock Exchange. But coming events cast their shadows before them and it will be understandably supposed that the activities of different parts of a prospective integrated financial services group will be increasingly influenced by what will be seen as a fast approaching identity of interest.

The City cannot afford to let it be thought that it is passive in the face of these developments or indifferent as to whether or not there are arrangements in place to prevent abuse. If the opportunity to develop a more vigorous and competitive British securities industry is to be fully exploited, users of our markets—including those overseas—must be assured that our trading arrangements are fairly and reasonably, though not intrusively, regulated.

As you know, the regulatory system has been the subject of a searching analysis by Professor Gower. His recommendations, together with comments from a wide range of interested parties, now lie before the Secretary of State for Trade and Industry. The responses that I have seen show, as one might expect, many shades of opinion. There is a general, although certainly not universal, belief in the advantage of significant practitioner involvement in the regulatory process, with favour widely found for channelling this through some structure of self-regulatory groupings. There is, however, no common view about what particular groupings any such structure should comprise; and there is still a rather sharp divergence of opinion on how far the activities of self-regulatory groupings would require co-ordination and how this might best be provided. I think that provision for appropriate oversight of the activities of self-regulatory bodies is not only a very difficult issue but also one of great importance. A particular consideration will be the relationship between any overall co-ordinating body and what must be acknowledged as the senior self-regulatory institution in the financial services industry, namely the Stock Exchange. In this context, I was impressed to see the comments submitted by the Stock Exchange on the Gower report, for these display the readiness of your Council to collaborate in arrangements under which the Stock Exchange would, as a self-regulatory association, be subject to a newly constituted overall supervisory body.

The Stock Exchange has, of course, long been an important contributor to the wider framework of self-regulation, where the City has an enviable record. The Take-over Panel, for example, whose code the Stock Exchange helps to enforce, is now admired internationally for its speed and efficiency in handling take-over disputes. The Council for the Securities Industry (CSI), which originated in an initiative taken by my predecessor, also has very substantial achievements to its credit and has steadily gained in authority under its distinguished Chairman, Sir Patrick Neill.

The way forward

With this record of successful self-regulation in mind and because I believe that the time is now ripe to move ahead from discussion on concepts to specific action, I have decided to constitute an advisory group of senior City figures and practitioners to advise me as a matter of urgency on the structure and operation of self-regulatory groupings which they would feel confident could in

practice be formed in the near future. The precise terms of reference are as follows:

> To advise 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, and which would, in the view of the group, attract sufficient support from potential participants to be capable of early implementation; on how, and over what time period, the formation of such new groupings as are needed might be brought about; and to tender advice to the Governor within three months.

I am happy to say that Mr Martin Jacomb, a Vice Chairman of Kleinwort Benson has accepted my invitation to act as Chairman of the group and that your own Chairman, Sir Nicholas Goodison, together with Mr John Barkshire, Chairman of Mercantile House, Mr Brian Corby, Chief Executive of the Prudential Corporation, Mr David Hopkinson, Chairman of M & G Investment, Mr Mackworth-Young, Chairman of Morgan Grenfell, Sir Jeremy Morse, Chairman of Lloyds Bank, Mr David Scholey, Joint Chairman of Warburgs, Mr Mark Weinberg, Chairman of Hambro Life Assurance and Mr Richard Westmacott, Senior Partner of Hoare Govett have agreed to serve on it. I should emphasise that there are no presumptions on my part about the answers to be reached and, indeed, with so well-qualified and distinguished a group, it would be presumptuous for any of us to anticipate their advice. There will be nothing to inhibit the group from giving whatever advice about the regulatory structure their consultations and deliberations lead them to consider appropriate. But while it is strictly an advisory group, my intention is that its advice should be formulated on the basis of what its members, by virtue of their respective positions in the City, judge to be capable of implementation.

Some of you may wonder why I did not entrust this task to the CSI but I think a moment's reflection will show you that it would have been unreasonable to do so. The CSI produced a most impressive analysis of and commentary on Professor Gower's recommended structure and has formulated its own carefully thought out and cogently argued proposals. Its studies have quite properly approached the question of regulatory structure from the point of view of what it sees as desirable. But what I am most immediately concerned with is what arrangements are capable of being put in place in the fairly early future. Whether strengthened regulatory arrangements that might in practice be put in place fairly soon will be regarded as sufficient over a slightly longer time-scale remains to be seen. But I am clear that early initiative is needed to equip us better to address the new conflict of interest situations that are beginning to emerge. It is for this reason that I am setting up this advisory group now with particular emphasis, in its terms of reference, to what is 'do-able'. I know that the Chairman and the CSI itself recognise that this is, in present circumstances, much more a task for an ad hoc group of the kind that I have described than for the CSI.

But I would like to take this opportunity to pay tribute to the quality of the work that has been undertaken by the CSI and its staff in this area, and I have no doubt that the advisory group will find it to be a very significant input to their deliberations. I am glad to say that the Chairman has agreed to place at the disposal of the advisory group the services of the senior executive staff who have been most closely involved in the work. The functions and composition of the CSI in the longer term will of course need to be reviewed in part in the light of the advice that I receive from the advisory group, and decisions that are reached, including those reached by government, in due course. But the CSI remains in being in its present form in the meantime; it has a continuing job to do and it has my support in doing it.

The initiative I have taken will serve as a means of testing how far strengthened non-statutory arrangements can meet the challenge of the fast-changing securities scene. I cannot of course be bound by the eventual proposals of this group, though I hope that their advice will commend itself to all concerned and provide the recipe for strengthening the regulatory structure in the securities area in a way that will command respect and confidence both at home and abroad.

Even stout hearts may falter slightly when they contemplate the difficult terrain that must be negotiated before we reach that as yet only dimly perceived state in which a regenerated stock exchange is smoothly functioning within a suitably regulated financial services sector. But we must not let ourselves be daunted. We have already travelled far since July of last year and many troublesome issues which seemed intractable in prospect now lie behind us and no longer represent problems. The knowledge of progress already made reinforces my conviction that, however difficult the remaining questions may now seem, we shall find good answers to them within the time that is available to us. I am equally confident that this process of change which we are undergoing, uncomfortable though it may be in some respects, offers many opportunities for growth and development, which I know you and your fellow members of the Stock Exchange will not be slow to identify and grasp.