Change in The Stock Exchange and regulation of the City

This article[1] surveys the changes that are in train in The Stock Exchange and in the regulation of the financial services industry, which together will transform the structure of the City.

By the end of 1986, The Stock Exchange will have abolished its minimum commissions scales and permitted 100% ownership of a member firm by a single non-member, and dual capacity trading systems will have been introduced in the gilt-edged and equity markets.

The Government is aiming to have a Financial Services Act on the statute book by end-1986, which would provide statutory backing for a comprehensive practitioner-based system of regulation for the financial services industry.

Introduction

The City transformation which will take place next year is a response to a wide range of pressures. Change in The Stock Exchange is necessary to enable it to meet the pressures from an increasingly competitive and international securities market. In comparison with much of the post-war period, investors, issuers and market participants, worldwide, are becoming more outward looking and more willing to look for opportunities in foreign markets. The change in The Stock Exchange will enable member firms to compete more effectively in this environment. The change in the ownership rules will enable firms to become better capitalised and also to become part of groupings spanning a very wide range of financial services. This, combined with the end of minimum commissions and the introduction of dual capacity trading, which is scheduled to take place on a single date (the Big Bang) in October of next year, will enable firms to offer a more flexible and low cost service. These developments and also the entry of a number of new players, including large foreign securities houses, to the listed securities markets should help to make the markets themselves more attractive both to domestic issuers and investors and to foreign customers.

Of course these changes are not without dangers. Firms will be able to expose themselves to a wider range of risks and will need to manage these risks adequately. The creation of large financial services conglomerates will also result in an increase in the conflicts of interest which practitioners might face. A group could encompass a wide range of functions, including market making, fund management, corporate finance and banking, which could lead to conflicts between the interests of the firm and the interests of some of its customers. This has given added impetus to the moves that are afoot to create a comprehensive regulatory regime for the financial services industry to ensure that the system remains sound and that investors can be confident of fair treatment from market practitioners.

The proposed regulatory system would be practitioner-based but in a statutory framework. The involvement of practitioners should help to ensure that the system is flexible enough to be effective in rapidly changing, competitive markets. The proposed financial services legislation, which would provide the statutory backing for this system, would require all investment businesses to be authorised. To obtain authorisation, a firm would have to show itself to be fit and proper, reflecting probity, competence and adequacy of financial resources and, once authorised, would have to keep to detailed rules regarding its conduct of business. The practitioner-based boards and the self-regulatory organisations recognised by them would set these rules and have powers to enforce them. The various regulatory regimes, including the embryo practitioner boards, are at present examining possible co-operative arrangements that would reduce the burden on firms from the degree of overlap that would exist both inside the proposed regulatory regime and between this regime and others in the financial area.

Restructuring of The Stock Exchange

Background

The UK Stock Exchange provides a central market in the shares and domestic corporate bonds of UK companies and in gilt-edged and other public sector securities. It also lists and provides a market in the equities and bonds of a number of foreign companies and governments and eurobonds (see Table A). The market capitalisation of the shares of non-UK companies listed on the Exchange is almost three times that of the shares of UK companies, but active trading in the securities of non-UK entities is concentrated in particular types of stocks (eg Australian shares) that account for a relatively modest proportion of the total.

(1) Written by Mrs P D Jackson of the Bank's Financial Supervision—General Division.

Table A
Securities listed on The Stock Exchange or included in the Unlisted Securities Market: 30 September 1985

	Number of securities	Market value (£ billions)	Percentage of market value
UK public sector	385	127.1	11.8
Non-UK public sector	260	9.9	0.9
Eurobonds	1,184	75.6	7.0
Company securities UK-registered	4,402	233.8	21.7
Company securities non-UK registered	696	626.7	58.2
Sub-total: main market	6,927	1,073.1	99.6
USM company securities	324	3.6	0.4
Total	**7,251**	**1,076.7**	

The Stock Exchange provides a central market in the domestic securities of UK entities in the sense that by far the greater part of trades in those securities take place on the Exchange. The picture for equities is complicated, however, by the active market in around twenty to thirty UK equities traded in American Depositary Receipt (ADR) form in the United States (the underlying securities are held by a bank acting as a depositary, and the receipt is traded as a bearer security). The main market in the shares of a handful of these UK companies has shifted to the ADR market. Trading in ADR form appears to account for around 7% of the turnover in the FTSE 100 stocks. But this appears to reflect demand from US investors rather than off-market trading on behalf of UK investors. There has also been some competition to the central market in equities from one merchant bank and a few foreign investment banks that hold themselves out in London as off-market traders in some major UK equities; but an informal survey by the Bank in the first half of this year indicated that the overall volume of such business was modest.

The current structure of the Exchange

The Stock Exchange consists of 4,852 individual members in 209 member firms (mostly partnerships). It is organised in terms of a strict separation of capacity between broking firms and dealers (jobbers). Most of the member firms (192) are brokers, who act as agents for investors (arranging deals on their behalf with the jobbers for a minimum commission).[1] Brokers are able to put together matched trades (put throughs) but the price must be checked by a jobber before the trade is agreed and the transaction must take place through the jobber's book. Such deals account for around 10% of the volume of transactions in equities. Brokers also manage investment portfolios and provide investment advice. A fund management survey[2] carried out by the Bank earlier this year indicated that at end-1984 Stock Exchange brokers managed funds totalling £11 billion for UK residents and a further £3 billion for non-residents and advised on the structure of portfolios totalling £32 billion. Although the twenty largest firms account for around 70% of the market in terms of commission income, the broking market is not particularly concentrated, with no one firm having more than around 10% of the whole market.

The market structure is one of competing market makers on the floor of the Exchange, with anywhere between two[3] and twelve jobbers registered as market makers in a particular stock. The jobbing system is highly concentrated, however. Only five of the seventeen firms are in general in a position to handle deals of institutional size, and two of those firms dominate the gilts market and also have a large share of the equity market. Jobbers have no direct contact with non-members.

One notable feature of the current market structure is the limited information on actual jobbers' quotes (as opposed to indicative prices) and on the prices at which deals are struck. The bid and offer quotations of individual jobbers are not disseminated to the market at large. Each jobber will quote a price privately to a broker when approached—a broker will approach several jobbers on the floor of the Exchange to ascertain the best market price. Because the jobbers alter their prices to achieve the desired order flow, their prices are usually broadly in line. Only if a jobber's price is so out of line with those of his competitors that the offer price of one firm is lower than the bid price of another will a broker disclose the fact to the jobber and enable him to change his quote. The Exchange staff collect indicative prices from jobbers continuously during the day and an indicative mid-price for bargains of average market size is displayed on TOPIC[4] screens. The brokers also disseminate indications of jobbers' bid and offer prices to groups of their clients. The details of individual deals (price and size) are not disseminated—although the daily official list, published the following day, carries a list of prices in ascending order,[5] there is no indication of the time a deal was struck or the size of a deal or the number of deals struck at any price. The limited disclosure of information on prices has always been regarded as an important protection for the jobbers and hence for the liquidity of the market. Investors are protected in this environment by the strict separation of capacity—the role of the brokers is to ensure that deals are struck at the best available price in the market.

No figures are available for the capitalisation of the Exchange but member firms are known to have modest capital in comparison with firms in some foreign markets, particularly the United States. This is in part because of the single capacity system. The brokers do not need substantial capital because their agency, advisory and

(1) Transactions in short-dated securities, with less than five years to run, have always been at negotiated commission whereas other domestic securities have been covered by minimum commission schedules since 1912.
(2) 'Investment management in the United Kingdom': June 1985 *Bulletin*, page 212.
(3) There are a few illiquid stocks with a single jobber.
(4) Teletext Output of Price Information by Computer—the Stock Exchange's viewdata system which disseminates prices, company news and other information to its subscribers.
(5) Firms are not compelled to report prices of deals for inclusion in the daily official list unless the deal was a 'put through'—but the list carries 90% of prices.

investment management functions do not involve major risk taking. The jobbers have been able to handle a substantial volume of business with a modest amount of capital because of the concentration of the order flow—the brokers feed the orders to the relatively small number of jobbers. Any member firms that wished to seek additional capital have been constrained, moreover, by the rules restricting the outside ownership of member firms. Traditionally, member firms had to be partnerships; changes to this rule in 1969 allowed member firms to become limited companies[1] and take outside shareholders, but a limit of 10% was placed on shareholdings in a member firm by any single non-member. In 1982, this limit was increased to 29.9%, but the fact that member firms could not be wholly owned by a single non-member meant that firms could not become part of wider groupings.

The pressures for change

Pressures for change in the structure of The Stock Exchange have come from a number of directions. Financial markets are becoming more closely integrated and competitive. Investors, particularly institutions, are tending to look for an international spread of investments and are attracted towards liquid and efficient markets. Liquidity is important because it enables investors to trade large blocks of stock, with ease, at prices close to the mid-market price. The internationalisation of savings flows reflects in part specific policy measures, such as the 1974 Employee Retirement Income Security Act in the United States and the removal of exchange controls in the United Kingdom in 1979. Technological developments have encouraged the integration of markets by enabling market information to be disseminated worldwide, virtually instantaneously, and facilitating trading in distant markets. At the same time corporate treasurers have become more inclined to look outside their home market for attractive sources of bond and equity finance.

Stock Exchange members have been constrained in their ability to compete in these increasingly international markets by three central elements of The Stock Exchange rule book. First, the minimum commission arrangements restrain member firms' competition with one another, and with dealers in securities outside The Stock Exchange. Securities firms in some other markets operate in a more freely competitive environment. For example, the New York Stock Exchange has had negotiated commissions since May 1975. Second, the single capacity system prevented the development of flexible methods of doing business. Finally, the ownership rules, by preventing Stock Exchange firms from becoming part of wider groupings and limiting their access to outside capital, have prevented firms from developing new types of capital intensive activities.

Many Stock Exchange members have long recognised the need to adapt to meet the various challenges. From the late 1970s, however, the Exchange was facing a challenge to its business methods in the Restrictive Practices Court.[2] In the light of this, the Exchange was not willing to consider changes in its rule book which might have weakened its defence. In July 1983, the flood gates were opened by the Government's decision to exempt The Stock Exchange from the Restrictive Trade Practices Act, subject to their agreement to abolish fixed minimum commissions by the end of 1986 and to make certain changes to their constitution, notably the inclusion of lay members in the Council. Following this agreement, The Stock Exchange came to the conclusion that, with the abolition of fixed commissions, a dual capacity dealing system would have to be introduced. It followed that such a dual capacity trading system would increase the need for member firms to have free access to outside capital and the Exchange therefore decided to change the ownership rules.

The new Stock Exchange structure

The first major development next year will be a change in the ownership rules on 1 March, to enable a single non-member to own 100% of a member firm. From that date, a large number of Stock Exchange firms will be part of financial services conglomerates, a number of which will include a UK or foreign bank. The foundations for such conglomerates have already been laid in anticipation of this change. Participations of up to 29.9% have been purchased in all the five large jobbers, in nineteen out of the twenty largest brokers and in a number of smaller member firms (see Table B). A number of the groupings will involve the merger of an existing jobber and an existing broker. For example, one of the conglomerates will include a UK merchant bank, one of the largest jobbers and two large brokers. All Stock Exchange member firms will, however, have to be separately capitalised entities within any wider grouping.

Table B
Participations in UK Stock Exchange member firms

Outside entities	Number of outside entities	Top 5 jobbers	Other jobbers	Top 20 brokers	Other brokers	**Total particip-ations**
UK clearing banks	3(a)	2	—	3	1	**6**
UK merchant banks	11	3	3	4(b)	6(b)	**16**
Other UK financial institutions	10	—	1	1	9	**11**
Other UK entities	3	—	—	1	1	**2**
US Commercial banks	4	—	1	4	4	**9**
US investment banks	3	—	1	1	1	**3**
Other foreign financial institutions	12	—	2	5	9	**16**
Total	46	5	8	19	31	**63**

(a) Including participations taken by merchant banking arms.
(b) Including a prospective merger which has been announced.

(1) Although the firms could be limited companies, the individual members of the Exchange retained unlimited liability for the debts of the Exchange.
(2) The Stock Exchange was brought within the scope of the restrictive practices legislation by the Restrictive Trade Practices (Services) Order 1976. The Office of Fair Trading referred the Exchange to the Restrictive Practices Court in 1979.

Also from 1 March 1986, The Stock Exchange is to lift a moratorium, imposed in July 1984, on the creation of new member firms with outside financing. This will enable non-Exchange entities to set up new firms from scratch, without having to buy into an existing firm. But it is proposed that the current single capacity trading arrangements in the domestic market should be retained until the abolition of minimum commissions, which is scheduled for October next year.

Dual capacity dealing by Stock Exchange members in non-UK stocks has been allowed since April 1984 when member firms were for the first time permitted under Stock Exchange rules to set up International Dealing (ID) subsidiaries to deal in such stocks. IDs may act as agents or principals and may be owned by brokers or jobbers or jointly by both. The foreign subsidiaries of IDs are able to deal in UK equities in ADR form with foreign investors in the domestic market of those foreign investors. They are not able to transact deals in ADRs of UK equities with UK residents. This is to ensure that the single capacity system is not undermined in the run-up to the introduction of the new dual capacity equity market. Also in April 1984 the Exchange removed the minimum commission schedules for deals in overseas securities.

The new equity market structure, which will be introduced at the time of the Big Bang, will be a quote-driven, competing-market-maker system[1] (it will be the same for both the listed and unlisted securities markets in the Exchange). All firms (whether market makers or broker-dealers) will be able to act in dual capacity—they will be able to deal direct with investors (buying and selling securities from their own book), or to act as agent, putting a deal together for negotiated commission on a client's behalf. Firms will also have the option of registering as a market maker in any equities, while at the same time acting as a broker-dealer in other stocks. Market makers will be obliged to maintain firm two-way quotes for deals of normal market size at all times on an electronic quotation dissemination system (SEAQ)[2]—although in some inactive stocks they may be able to limit their two-way quotes to indicative prices. This, combined with central monitoring of spreads by the Exchange, should ensure a continuous market whatever the state of sentiment. Firms will be able to withdraw from market making in a particular stock at short notice but they would not be able to re-register as market makers in that stock for a set period (perhaps three months). The Exchange has suggested that normal market size should be 1,000 shares but firms will have the option of posting firm quotes for deals of larger size.

This obligation will be balanced by a number of privileges. Only registered market makers will be able to display prices on the SEAQ system, which will help them to attract business. Business in normal market size will tend to be channelled to the market makers because of a 'best execution' rule which will prevent broker-dealers from dealing direct with an investor unless they can better the price which could be obtained by effecting an agency transaction with a market maker. For this purpose normal market size will be taken as the size of deal for which firm quotes are available on SEAQ, which will encourage market makers to post quotes for deals of larger size than the minimum. The SEAQ screens will be limited to information dissemination; they will not be used to conduct dealing. Deals between market participants will be arranged by telephone or on the floor of the Exchange. The floor may remain important for the transaction of small deals but it will probably decline in importance for the handling of large blocks of stock. In time, the Exchange will develop an automated small-order-execution service which would handle small deals at low cost and would lead to a further reduction in floor business. SEAQ screens, carrying the quotes of individual market makers, will be available to both member firms and major investors. A further innovation will be the introduction of a tape displaying the size and price of deals in active shares in which there are a number of market makers.

In consultation with market participants, The Stock Exchange and the Bank of England have jointly developed a new structure for the gilt-edged market. Broker-dealers in gilts will come under similar rules to those for equities dealers—indeed such firms will be able to deal in both gilts and equities. At the core of the gilts market will be market-making firms, which in return for a dealing relationship with the Bank and access to various technical facilities (see below) will undertake an obligation to make, on demand and in any trading conditions, continuous and effective two-way prices. They will be expected to deal only in sterling fixed-interest, floating-rate or indexed securities and related instruments (eg gilt-edged futures and traded options), and approved sterling money-market instruments.

Market makers will be able to deal direct with one another or through a system of inter-dealer brokers (IDBs). Market makers subscribing to an IDB system would be able to feed bid and offer quotations to the IDB, who would display the best bid and the best offer on his network of electronic screens. A market maker wishing to deal at a price shown on the screen would contact the IDB by telephone. The IDBs will match the two sides of a deal but will act as principals in each transaction, thereby concealing the identity of each of the ultimate counterparties. Investors and other Stock Exchange firms will not have access to IDB screens. Market markers will also have the option of quoting prices on the SEAQ system. Market makers, unlike broker-dealers, will be able to borrow stock. The Bank is not prepared at this stage, essentially for prudential reasons, to envisage the development of a broadly based market in repurchase agreements in government securities such as exists in the

(1) Similar to the arrangements in the US NASDAQ (National Association of Securities Dealers Automated Quotations) market.
(2) Stock Exchange Automated Quotations.

United States. The arrangements for regulated stock borrowing and lending to facilitate market liquidity will therefore continue broadly as at present, with stock lent by approved lenders through the intermediation of approved Stock Exchange money brokers to approved borrowers. Gilt-edged market makers will be both approved lenders and approved borrowers.

In order to ensure that the gilt-edged market as a whole is subject to Stock Exchange regulation as far as trading practices and professional standards are concerned, the market makers,Stock Exchange money brokers and IDBs will be required to be members of The Stock Exchange. The Bank will require them to have dedicated sterling capital in this country and will maintain close supervision of the adequacy of their capital in relation to their exposure to risks of various kinds, as well as monitoring the performance of their functional obligations. The Stock Exchange will be responsible for all other aspects of market supervision, including the supervision of capital adequacy of all other Stock Exchange members.

In June this year the Bank announced the names of 29 prospective gilt-edged market makers (with a total intended capitalisation of £600–£700 million). In August, the names of nine potential Stock Exchange money brokers and six potential IDBs were announced. The Bank will consider further applications from prospective participants on an open-ended basis, at any time after around twelve months has elapsed following the start of the new market.

The Stock Exchange will introduce new rules to protect clients in these dual capacity equity and gilt-edged markets, to ensure that investors are not disadvantaged by the end of the strict single capacity system. Firms will be required to report, promptly, the details of all trades, price and size, to regulatory officials monitoring the market. This will ensure that firms dealing with investors as principals do so at fair prices and that prices on agency trades are the best available. An enhanced daily official list will be published showing the prices of deals grouped into hourly periods—the sizes of deals in active equities will also be shown. An 'audit trail' detailing the terms and time of deals will be maintained by the Exchange to enable action to be taken on investors' complaints.

One consequence of the new dual capacity environment will be the increase in conflicts of interest for member firms. For example, a firm offering advice, or managing funds, might also be a trader or a market maker in some stocks and therefore likely to be holding positions in various securities. The Exchange is at present devising new rules to ensure that the conflicts of interests which will arise from the combination of these activities will not lead to abuses.

Regulation of the financial services industry

The changes in the structure of The Stock Exchange are taking place at the same time as a major alteration in the regulatory structure of the financial services industry as a whole.

The current regulatory structure

The foundations of the current regulatory structure for the securities industry date back to the pre-war period. Share pushing by fraudulent dealers in securities in the 1930s led to the creation of a new statute, the Prevention of Fraud (Investments) Act (the PFI Act), to ensure that all securities dealers that were not members of a reputable self-regulatory organisation such as The Stock Exchange obtained a licence from the then Board of Trade. There are at present some 600 securities dealers licensed by the Department of Trade and Industry under the PFI Act and required to adhere to licensed dealer rules laid down by the DTI. These firms account for a very small part of the securities business carried out in the United Kingdom. The majority of firms involved in the securities industry are exempt from the need to obtain a licence because of their membership of The Stock Exchange or of one of eight associations of dealers in securities recognised by the DTI, including groups of foreign houses such as the United Kingdom Association of New York Stock Exchange Members; in addition, some 350 firms, including merchant banks, licensed deposit takers and insurance companies are exempt under a provision in the PFI Act which enables a firm to have an exemption if its main business is something other than securities dealing, or if such dealing is limited to particular types of activity such as issuing prospectuses, underwriting securities or dealing only with professionals. Such firms must conduct the majority of their business through a member of a stock exchange (the UK Stock Exchange or a recognised foreign exchange) or through a licensed dealer, and are expected to comply with the licensed dealer rules—although their compliance is not monitored.

The pressures for a review of the system

This regulatory structure leads to inconsistencies of treatment between the various firms involved in the securities industry. The system has also not proved flexible enough to keep pace with the changing structure of the securities and investments industry. The development of new products such as the futures markets in commodities has led to gaps in coverage—commodity futures are not securities and are, therefore, not covered by the PFI Act. The failure of several firms involved in investment management, in particular the failure of Norton Warburg in February 1981 with losses of large sums by individual investors, drew attention to the deficiencies of the system. In July 1981, Professor Gower was commissioned by the then Secretary of State for Trade and Industry to undertake a review of the regulatory system. In early 1982, Professor Gower published a comprehensive discussion document on the shortcomings of the existing system and followed this with the publication, in January 1984, of recommendations for the creation of a comprehensive regulatory system for the securities and investments industry. He suggested that, to ensure adequate flexibility, considerable reliance should be placed on the use of practitioners to carry out the regulation. In January 1985, following consideration of the Gower Report and consultations with practitioners, the Government published a White Paper on the financial services industry which set out proposals for practitioner-based regulation within a statutory framework.[1]

The proposed legislation

The statutory framework would be provided by a Financial Services Act which the Government is aiming to have on the statute book by the end of next year. The proposed legislation has a very wide scope. It would make it a criminal offence for any firm to carry on an investment business unless authorised and would set out a framework for conduct for investment business. The definition of an investment would include financial and commodity futures and options contracts, securities, unit trust units, long-term insurance contracts and some other products. Transactions in physical commodities and property, or other such products that pass, when purchased, under the direct physical control of the investor would be excluded from the definition of an investment. The definition of an investment business would include any firm which holds itself out in the UK as willing to transact business in investments with others or as an agent for others, or which manages investments or gives advice about them, or arranges for investment deals to be made. Insurance companies would continue to be authorised and supervised prudentially by the Department of Trade and Industry but the marketing of life assurance contracts would be regulated under the Financial Services Act, ensuring that they are treated on the same footing as comparable investments.

The proposed legislation would give the Secretary of State for Trade and Industry the power to authorise investment businesses that are fit and proper. This would involve judging whether applicant firms met the required standards of probity, competence and adequacy of financial resources. He would have power to regulate their activities, including laying down detailed business conduct rules. It is proposed, however, that he could transfer these powers to one or more practitioner-based boards, if he were satisfied that their rules and practices were adequate to ensure that authorised businesses were fit and proper and that their business conduct rules were adequate to protect investors. The boards would be able to authorise and regulate investment businesses directly or to recognise self-regulatory organisations (SROs), whose rules and enforcement procedures provided a standard of investor protection at least equivalent to that of the boards. An investment business would be able to obtain authorisation through membership of an SRO as an alternative to direct authorisation by a board. But the board would retain the statutory obligation to ensure that the regulatory regime imposed by the SROs was adequate.

There would be similar provisions for members of professional bodies eg accountants, solicitors and actuaries, who carried on investment business incidentally to the conduct of their main profession.

Under this system, the powers, if transferred to the boards, would enable them to make rules with the force of law and ensure that businesses complied with them. The delegation of such wide powers to private sector bodies is unprecedented but a number of safeguards would be built into the system:

- the chairmen of the boards and board members would be appointed by the Secretary of State and the Governor of the Bank of England according to a formula laid down in the legislation;
- the Secretary of State would be able to resume regulatory responsibility from a board if it ceased to conform to the requirements set out in the legislation;
- the boards would be obliged to report annually to the Secretary of State who would lay their reports before Parliament;
- the decisions of the boards on authorisation of investment businesses and on disciplinary matters would be referable to an independent tribunal appointed by the Lord Chancellor and the Secretary of State;
- the Secretary of State would be able to require the revocation or amendment of the rules of the boards if they were contrary to the United Kingdom's international obligations;
- after obtaining advice from the Director General of Fair Trading, the Secretary of State would be able to require a board to change or remove a rule if it were judged detrimental to competition to an extent unjustified by the requirements of investor protection.

The conduct of business rules of the boards and the SROs would be based on various general principles laid down in the legislation. These would include a principle of fair dealing, a duty of skill, care and diligence and a duty to disclose (for example any material interest in a proposed transaction). The boards and the SROs would also have to ensure that clients' assets were adequately protected, through segregation of clients' funds and through compensation schemes. Failure of an authorised business to comply with the detailed rules based on any of the principles would be grounds for disciplinary sanction, and, where relevant, civil action. SROs would have a range of sanctions at their disposal including, in extreme cases, withdrawal of membership. The boards would be able to censure firms which they had directly authorised or to

(1) *Financial Services in the United Kingdom* (Cmnd 9432) January 1985.

remove or suspend their authorisation. The boards and the SROs would also have powers to intervene in the affairs of an authorised business.

The proposed practitioner-based system

The legislation would provide the statutory backing for the new practitioner-based system, but the detailed structure in terms of the number of boards and the number of SROs will depend upon the outcome of preparatory work which is currently taking place in the City. Earlier this year general opinion among market practitioners appeared to favour two separate practitioner-based Boards—a Securities and Investments Board (SIB), and a Marketing of Investments Board (MIB) to regulate the marketing of collective investments including unit trusts and long-term insurance contracts. In the light of this, an embryonic SIB and an organising committee for the MIB (MIBOC) were established. Since then opinion among practitioners has shifted in favour of a single board and it is possible that the two will be combined.

The SIB and MIBOC have devoted a considerable amount of energy to the design of an SRO structure. The Financial Services White Paper mentioned four potential SROs—The Stock Exchange, the National Association of Securities Dealers and Investment Managers (NASDIM), the Association of Futures Brokers and Dealers (AFBD) and the Insurance Brokers Registration Council (IBRC). In recent months, the SIB has received proposals from a group of major investment managers for an Investment Management SRO (IMRO) and from a group of major overseas and British banks for the establishment of a eurobond and other international securities SRO (ISRO).(1) There are likely to be two SROs covering the marketing of collective investments, which would subsume the IBRC.

In all there could be around six or seven SROs covering various aspects of the securities and investments area. The SIB would also be able to recognise investment exchanges that make adequate provision for prices to be determined in a fair and open way and have adequate settlement systems. Authorised businesses would be encouraged to transact business through a recognised exchange because this would give a guarantee that certain SIB/SRO rules would be met—for example, the rules concerning fair prices would entail less arduous checking procedures by an authorised business for deals transacted on a recognised exchange, because the exchange would have systems to ensure an adequate price discovery process. The Stock Exchange is likely to be an SRO as well as a recognised exchange for domestic securities. Talks are taking place on a proposal that The Stock Exchange and ISRO should jointly operate a recognised investment exchange for international equities. The SIB is also discussing the possibility that the Swiss-based Association of International Bond Dealers (AIBD) should form a recognised investment exchange for the eurobond market (the eurobond market is at present a largely unregulated over-the-counter market).

Overlapping regulatory structures

The proposed financial services legislation would create a single coherent structure for the regulation of investment business as defined in the Act. But there would be regulatory overlaps both within this supervisory system (because of the existence of one or more boards and several SROs and investment exchanges) and between this system and other regulators in the financial area.

Within the financial services regulatory system, a single firm might be regulated by a number of SROs. Alternatively, a single firm might be both a member of an SRO and directly authorised by the SIB. This is because an SRO's regulatory scope would be limited to its area of expertise. Thus a firm wishing to carry out business in futures and eurobonds might be a member of both the AFBD and ISRO. Each SRO and the SIB would need to have requirements as to whether a firm was fit and proper (which might encompass all of the activities of the firm and capital adequacy of the firm as a whole) as well as business conduct rules covering the specific area of expertise of the SRO. Discussions are currently taking place on ways of ensuring that firms are not overburdened because of these overlaps.

Discussions are also taking place to minimise the problems that could result from overlaps between the financial services regulatory regime and other regulators in the financial area. One of the most important areas of overlap would be between the regulatory regime for investment businesses and that for banks. Any banks that wished to carry on an investment business as defined under the Financial Services Act would need to have direct authorisation from the SIB or to be a member of one or more SROs. Insurance companies authorised by the Department of Trade and Industry under the Insurance Companies Act would be regulated under the Financial Services Act for the marketing of long-term investments and for any management of pension funds. It is also possible that, in the future, Building Societies, already regulated under the Building Societies Act, could start to engage in investment business such as the marketing of life assurance, which would bring them within the scope of the financial services legislation. As the Banking Act and the Building Societies Act are concerned with the protection of depositors' funds through prudential supervision of the entities concerned and with compensation schemes, rather than with detailed conduct of business rules, the degree of overlap between the regulatory regimes would mainly cover whether those concerned were fit and proper to carry on investment business, including questions of probity, competence and adequacy of financial resources.

(1) International Securities Self Regulatory Organisation.