City regulation after Big Bang

*The **Governor** reviews[1] the planned changes in the regulation of financial services in the United Kingdom following the major reforms now under way in the securities industry.*

*In the more competitive environment after 'Big Bang', both the risks and the scope for conflicts of interest will increase, reinforcing the need to strengthen market regulation and investor protection. The **Governor** argues that the proposed new regulatory framework to meet these needs—which will be based on statute but, in keeping with the City's tradition of regulation by consensus, will be run primarily by practitioners—offers a combination which should provide effective investor protection while retaining flexibility of response to structural change.*

In a broader context, he goes on to stress the importance of the establishment of effective arrangements for co-operation and exchanges of information between different regulatory authorities, both within the United Kingdom and internationally.

I am greatly honoured to have the opportunity to speak to you on this occasion. Looking down the impressive list of speakers at previous gatherings, I can well imagine that you are accustomed to a rich and varied diet. For my part, I would like to concentrate on subjects close to home, in the City of London, and in the UK financial services industry more generally. London has a long tradition as an international financial centre, founded mainly on its ability to adapt to changing conditions at home and abroad. Our securities markets are currently undergoing a new and fundamental phase of change, culminating in our so called 'Big Bang' this October. By then we will have in place significantly more competitive trading arrangements, new market technology, and, perhaps most important of all, an influx of large, well-capitalised firms, many of them from overseas. I firmly believe that London's Big Bang will leave a greater mark on the landscape than did Mayday 1975 in New York.

The pressures for such change are international at source, aided by major advances in technology. Investors are eager to diversify their portfolios; borrowers are able and willing to look further afield for the best deal. And, of course, banks and securities houses are extending their international networks in order to fulfil these needs. Domestic securities markets are having to adapt merely to hold on to existing business. In the European time zone, Amsterdam, Frankfurt and Paris are also embarked on reforms in their securities markets. The stakes in this game are high: business is likely to gravitate towards the centres offering the lowest transactions costs, the most liquid markets, the widest range of financial instruments and services, and the surest settlement and communications systems. The size and depth of such markets are key factors. Maybe in this field participants are guided by Mr Pickwick's observation:

> 'It's always best on these occasions to do what the mob do.'
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> 'But suppose there are two mobs?' suggested Mr Snodgrass.
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> 'Shout with the largest,' replied Mr Pickwick.

I would not, of course, wish to suggest that an international financial centre such as London owes its existence to some kind of herd instinct. It is quite obvious that powerful market forces are at work, which should ensure an efficient matching of the needs of ultimate investors and borrowers. But it is a highly competitive and fluid environment, and although competition can exert its own form of discipline, it can generate risks too. At the end of the day, a financial centre will not flourish if potential users do not feel that it is safe.

It is with this in mind that the UK authorities are currently engaged in a major overhaul of the regulatory framework for the entire financial sector, spanning banks, building societies and other financial services. On this occasion I would like to restrict my remarks as far as possible to our plans in the third of these areas, financial services, although I recognise that it is becoming increasingly difficult to distinguish between different types of financial activity and institution.

Although a number of banks, notably our merchant banks, are already undertaking a range of financial activities, the approach of Big Bang has seen a proliferation of plans for forming large conglomerates to carry out banking, corporate advice, issuing, market making, and investment management all under one roof. Such combinations are familiar in continental Europe, in contrast to the legal separation of commercial banking and

(1) In a speech to the American Chamber of Commerce (United Kingdom) on 21 January.

securities business seen in the United States, Canada and Japan. It is interesting to note, however, that firms from these countries are not similarly constrained in London, where, for example, no fewer than ten US commercial banks have bought participations in Stock Exchange member firms.

By removing barriers between types of business that have traditionally been kept separate, these developments have increased the number of risks and the scope for conflicts of interest. They have reinforced the need to strengthen our systems of market regulation and investor protection. The legislation to tackle this is already in hand. During 1987, we should have in place a system of regulation that is firmly based in statute, but which is essentially run by practitioners. This combination should provide effective investor protection while being flexible enough to respond quickly to structural change. A practitioner-run system will, we believe, be better able to identify malpractice, and be less bureaucratic.

I must emphasise that this will not be soft regulation. The measures are designed to bring the whole range of investment products within the scope of the law. It will be a criminal offence to carry on an investment business without authorisation. Wide-ranging powers will be vested in the Secretary of State for Trade and Industry. But he intends to transfer most of these to a 'Designated Agency' which will have the task of devising and enforcing rules at a more detailed level. The agency in turn will have powers to recognise self-regulatory organisations—SROs—which will be responsible for maintaining standards of conduct and prudence among their members. It is important to note that the Secretary of State will not transfer his powers unless he is satisfied that the agency has adequate rules to protect investors and the necessary resources for enforcement. Likewise, the agency will not recognise SROs unless they meet equivalent standards.

The regulatory framework is now starting to take shape. The main elements are set out in the recently published Financial Services Bill. An embryo supervisory agency is already in existence—the Securities and Investment Board. And a total of seven potential SROs have been identified.

It has been argued—quite forcefully in some quarters—that the UK authorities should have opted for a fully statutory system of regulation, administered by a powerful independent body such as those in the United States, the Securities and Exchange Commission (SEC) and the Commodity Futures Trade Commission (CFTC).

In some respects, the UK and US regulatory structures are likely to be very similar. Like the SEC and CFTC, our agency will exercise functions based in statute and will preside over self-regulatory organisations, exchanges and clearing systems. The range of financial activities covered by our agency will be much the same as that of the SEC and CFTC combined.

The chain of accountability will differ between our two systems. The agency being set up in the United Kingdom, for example, will be a private company, financed by fees levied on investment businesses and SROs. No public funds are involved. It will administer statutory powers transferred to it by the Secretary of State for Trade and Industry, and will report to him annually. Its chairman and board of directors will be appointed by the Secretary of State and the Governor of the Bank of England acting jointly. The SEC, for its part, is established by a statute which also determines its powers. It reports annually to Congress, while its five full-time board members are each appointed for five-year terms by the President with the advice and consent of the Senate. The SEC relies on government funds and its budget has to be approved by Congress.

Within the structure I have outlined, it is envisaged that the UK agency will exercise some of its regulatory powers less directly than, say, the SEC. This should not be interpreted as a sign of weakness, more a reflection of cultural differences between our two countries. The City of London has a long tradition of regulation by consensus, and of the principle of being bound by the spirit of the rules as much as by their letter. Our experience suggests that a practitioner-oriented system can achieve all that a lawyer-oriented one can achieve, and more besides. I would like to see this tradition survive the move to a statutory framework and the influx of firms from different cultures.

The area covered by our financial services legislation will not be neatly self-contained, either for the regulators or for many of the businesses concerned. A significant number of financial conglomerates may need to be supervised by more than one regulatory organisation, possibly including the Bank of England in respect of their banking activities. Each of these supervisors remains responsible for his own particular area, and cannot give up that responsibility to others. But he must have regard to the activities going on elsewhere in the same firm. While the legislation is going through Parliament, procedures will need to be agreed permitting co-operation and exchanges of information between the various supervisors. The Bank of England will certainly co-operate with any efforts in this direction.

This approach may not, however, solve the problem where the parent of a conglomerate is a foreign securities firm outside UK jurisdiction. Whereas our banking supervisors are in a position to exchange information with their opposite numbers abroad, this facility does not yet formally exist among the regulators of securities markets. Some comfort can be drawn where a foreign securities firm is effectively regulated at home, but this is no substitute for the free flow of information between supervisors. I do not underestimate the difficulties involved, not least because of the fundamental differences between legal and regulatory systems, but it is vital that workable relationships are established between the securities markets regulators of different countries. I welcome the fact that our Department of Trade and

Industry and the SEC have agreed to hold bilateral discussions in this area.

The need for international supervisory co-operation is also pressing elsewhere. For instance, a growing number of securities are now being traded simultaneously on different markets around the world. In this environment it is difficult to know whether an orderly market is being maintained in a particular security—a problem which would not arise if it were listed and predominantly traded on a single exchange. In a similar vein, interest is being shown by exchanges in establishing formal trading links across national boundaries. Some already exist between stock exchanges in the United States and Canada. The London Stock Exchange is also exploring possible linkages with a number of organisations in the United States.

Issues such as these bring our regulatory systems into direct and unavoidable contact. Such linkages will have to be backed by explicit agreements on exchanges of regulatory information. More important perhaps, they bring our respective legal systems face to face. And I have to say that, from a UK point of view, it is daunting to contemplate the extent to which US official bodies claim to exercise authority outside US territory. The United Kingdom and other countries have defensive legislation which could be used, although the most productive approach would be to reach workable compromises on the limits of our respective jurisdictions. It would be a pity if trade in international securities, for example, were to flourish in relatively unregulated off-market locations because governments had failed to reach the necessary understandings to enable well-run central exchanges to form effective trading links.

On a more optimistic note, I do sense that some progress is being made on the subject of prospectuses. More and more, corporate borrowers are prepared to scan world markets to find the cheapest ways of raising finance. Or they may wish to offer securities simultaneously in several different markets. Their ability to do either of these things is easier if they do not have to comply with different listing and prospectus requirements. In the European Common Market area, we are moving in the direction of harmonisation. And the US, UK and Canadian authorities intend to hold discussions on the possibilities of mutual recognition of prospectuses issued by companies in their respective countries.

In conclusion, I would like to reiterate that the recently published proposals on regulating the financial services industry are designed to provide comprehensive safeguards for investors, while avoiding as far as possible bureaucratic and legalistic methods which might be slow to react to events, and which might stifle worthwhile innovation. To those calling for a system of regulation comparable to that in the United States, I would say that we are in the process of creating a system best suited to UK conditions. On a broader front, a great deal of thought will need to be given to arrangements for co-operation and for exchanges of information between the various regulatory bodies, both at home and abroad.

The reforms taking place in London open up substantial new opportunities for a wide range of financial intermediaries, both domestic and foreign. More important, if they are properly managed, these changes should generate significant benefits for the ultimate users of the services on offer, that is those raising capital and individual investors. And as I have stressed, our plans for the regulatory environment are designed to protect these benefits, and to reinforce London's position as a safe place in which to do business.