

# RE-REGULATION OF THE FINANCIAL SERVICES INDUSTRY IN THE UNITED KINGDOM\*

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## 1. INTRODUCTION

When discussing market structures and regulation of the financial services industry, distinctions are traditionally made between long-term saving, deposit banking and capital markets. These financial services were separated in distinct compartments in both the United States and the United Kingdom. Barriers, often fixed by legislation, constrained what the various financial intermediaires could and could not do, while within each compartment limitations were imposed upon competition in an effort to maintain the stability of the financial system as a whole. In both countries, this compartmentalization of market participants was reflected in the regulatory structure. The regulatory controls applicable to a certain type of market activity (which due to the compartmentalization was limited to a single type of firm) were enforced by a regulator or various regulators responsible for each type of activity. Specialized financial institutions thus did not only have their own domain but also their own regulator.<sup>1</sup>

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\* This article is based on a paper presented by the author to the Financial Services Seminar 1986-1987 at Boalt Hall School of Law, University of California, Berkeley, in May 1987. Major events have occurred since then. They have been taken into account in so far as they influenced the regulatory structure of the financial services industry in the United Kingdom.

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1. The Glass-Steagall Act separated commercial banking or loans from investment banking or underwriting securities. Banking Act of 1933, Pub. L. No. 73-66, §§ 16, 20, 21, 32, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.). The Bank Holding Company Act of 1956 restricted affiliation of banks with non-banking enterprises. 70 Stat. 133 (codified as amended in scattered sections of 12 U.S.C.). The Savings and Loan Holding Company Amendments of 1967 restricted the affiliation of thrifts with non-thrift institutions. Pub. L. No. 90-255, 82 Stat. 5 (1968)(codified at 12 U.S.C. § 1730a). Various state laws restricted affiliations between banks and other enterprises or their agents (especially insurance agents). See Huertas, *Redesigning Regulation: The Future of Finance in the United States*, in RESTRUCTURING THE FINANCIAL SYSTEM: A SYMPOSIUM SPONSORED BY THE FEDERAL RESERVE BANK OF KANSAS CITY 140 (1987). In the United Kingdom, the historical separation of the various financial services in distinct compartments and the creation of self-regulating clubs or associations in each compartment was encouraged by the Bank of England largely on a non-statutory basis. D'Havé & Quintyn, *Reguleren en dereguleren van*

These lines of demarcation have started to blur gradually, in part due to fundamental economic and technological changes. The blurring of the distinctions between banks and savings and loan institutions in the United States is very similar to developments in the United Kingdom, where clearing banks and building societies have entered into competition with one another. Both countries have also seen increasing efforts by deposit banking participants attempting to enter capital markets and vice versa.<sup>2</sup> In an attempt to accommodate these market forces, legal and regulatory loopholes have been increasingly exploited in the United States, but such exploitation has not necessarily been consistent with the goal of preserving financial stability or, arguably, with the best approach for the future.<sup>3</sup>

Notwithstanding these fundamental changes in market structure, the U.S. regulatory framework has remained essentially unchanged. At first, little attention seems to have been paid to the possible effects of these changes on the regulatory landscape. Congressional consensus on a regulatory response was lacking. In addition, there was no agreement among the industries involved and only partial agreement among the regulators. A consensus seemed to be growing, however, towards adopting a structure based on "functional" rather than on "institutional" regulation, and thus at regulating each common activity or product through a single agency, under a common set of rules, irrespective of the type of institution involved. A recent case dealing with Rule 3b-9 under the Securities Exchange Act of 1934 showed that functional regulation would not be viable unless Congress acted explicitly,<sup>4</sup> but such action seemed unlikely in light of the lack of a Congressional consensus.

A "functionally" oriented bill, sponsored by the Reagan Administration, was nevertheless introduced in both houses of Congress, but

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*de financiële sector in het Verenigd Koninkrijk*, 1987 REVUE DE LA BANQUE, No. 4, at 97; *The Economics of 'Big Bang'*, MIDLAND BANK REV., Summer 1987, at 6; Deputy Governor of the Bank of England, *The Business of Financial Supervision*, 24 BANK ENG. Q. BULL. 46 (1984); Governor of the Bank of England, *Shifting Frontiers in Financial Markets: Their Causes and Consequences*, 25 BANK ENG. Q. BULL. 207 (1985).

2. See Friedman & Friesen, *A New Paradigm for Financial Regulation: Getting From Here to There*, 43 MD. L. REV. 413, 428-42 (1984). For the United Kingdom, see George, *The City Revolution*, 25 BANK ENG. Q. BULL. 422 (1985).

3. Parry, *Major Trends in the U.S. Financial System: Implications and Issues*, FED. RESERVE BANK S.F. ECON. REV., Spring 1987, at 5; Huertas, *supra* note 1, at 145-47; Governor of the Bank of England, *supra* note 1, at 207.

4. *American Bankers Association v. SEC*, 804 F.2d 739 (D.C. Cir. 1986). Under Rule 3b-9, the Securities and Exchange Commission ("SEC") would require banks performing certain securities activities to register with the SEC as broker-dealer. Applicability of Broker-Dealer Registration to Banks, Securities Exchange Act of 1934 Release No. 34-20357, 48 Fed. Reg. 51,930 (Nov. 15, 1983) (to be codified at 17 C.F.R. § 240.3b-9).

was overshadowed at the time by more pressing issues such as the integrity of the savings and loan insurance system.<sup>5</sup> Meanwhile regulators continued to meet the demands of the market by broadly interpreting the existing statutory provisions, thereby furthering the diversification of financial intermediaries. In response, the Reagan Administration recently had to accept the closing of the "non-bank" bank loophole and a moratorium on certain "non-banking" activities that had been approved by bank regulators in exchange for Federal Savings and Loan Insurance Corporation ("FSLIC") recapitalization.<sup>6</sup>

When arguing in favor of a repeal of the Glass-Steagall Act, and full de-regulation of the U.S. financial markets, U.S. firms usually refer to the developments occurring in the British financial markets following the highly publicized "Big Bang." Following the market restructuring that had taken place due to the abolition of fixed commissions on the London Stock Exchange, a neat distinction of functions carried out by separate financial institutions was no longer possible.<sup>7</sup> However, the market restructuring was paralleled by fundamental changes in the British regulatory structure. Financial scandals have forced the Bank of England ("the Bank") and the Department of Trade and Industry ("DTI") to reconsider the existing regulatory framework in the United Kingdom and have resulted in the enactment of the Building Societies Act 1986, the Financial Services Act 1986 and the Banking Act 1987.

Some valuable insight can be drawn from the "re-regulatory" process that has occurred over the past five years in the United Kingdom. This article begins by discussing the regulatory structure that existed in the United Kingdom before "Big Bang." It then describes the current U.K. regulatory framework (statutory backed self-regulation), which is characterized by the presence of functional regulators that have to coop-

5. See Peters & Powers, *Functional Regulation - Looking Ahead*, 18 LOY. L.A. L. REV. 1075 (1985); Friedman & Friesen, *supra* note 2, at 454; *Functional Regulation, Other Provisions in Administration's Competitiveness Bill*, 48 BANKING REP. (BNA) 343 (Feb. 28, 1987).

6. Zweig, *Fed Ready to Hear Arguments for New Bank Powers*, Wall St. J., Feb. 2, 1987, at 6, col. 1; *Order Approving Applications to Engage in Limited Underwriting and Dealing in Certain Securities*, 73 FED. RESERVE BULL. 473 (1987); Norton, *Safe and Sound Banking under the US Banking Act*, 6 INT'L FIN. L. REV., Dec. 1987, at 13; Dufloux & Michel, *Le Temps de la Rd-réglementation Bancaire*, 1987 BANQUE 1193, 1194.

7. *The Big Bang Revisited: The Prospects for Securities Markets in Europe*, 1987 REVUE DE LA BANQUE, No. 7, at 33; *The Economics of 'Big Bang'*, *supra* note 1, at 7-9. However, one can question whether the 1987 Wall Street Crash has not seriously affected the U.S. firms' efforts to gain permission to engage directly in investment and underwriting activities in the future. *Comment: Shock Proof Glass*, 6 INT'L FIN. L. REV. Nov. 1987, at 2.

erate in their oversight of financial conglomerates active in several market segments. In a final evaluation, some of the U.S. re-regulation proposals will be compared briefly with the instruments put in place in the United Kingdom to achieve this regulatory cooperation.

## 2. THE FINANCIAL SERVICES INDUSTRY IN THE UNITED KINGDOM BEFORE "BIG BANG"

### 2.1. *The Market Structure in the United Kingdom*

#### 2.1.1. *Clearing Banks*

The London clearing banks were the most important providers of demand deposits for years. Because the clearing banks established cartel agreements in key areas like interest rates on deposits and loans (arrangements that were often condoned by the Bank of England) and because they had exclusive control and ownership of the nation's major funds transfer and check clearing system, entry into their oligopoly was hardly possible.<sup>8</sup>

No license or other supervisory requirement governed the taking of deposits from the public by institutions outside of the established banking system, which meant that entering into competition with the clearing banks in this area was relatively simple. When interest rates rose and the standard of living increased, lucrative banking opportunities developed for institutions other than the clearing banks. Following the post-war increase in personal income, these "secondary" banks started exploiting new banking markets such as the financing of auto and household good purchases as well as equipment leasing for businesses.<sup>9</sup>

Loosening most of the restrictions on the clearing banks, however, did not achieve the intended results. While the number of fringe banks was not reduced, the total amount of outstanding credit (especially real estate loans) grew and stimulated inflation. When restrictions were later reimposed, the resulting fears and the uncertainty about the property market led to the collapse of a finance company. The ensuing crisis of confidence in the secondary banking market forced the Bank of England to step in to mitigate the negative effect on the banking system as

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8. Gardener, *The City in Perspective*, 1986 REVUE DE LA BANQUE, No. 3 at 5; Governor of the Bank of England, *supra* note 1, at 207.

9. Clearing banks had been discouraged by the Bank of England from lending to individuals or to property concerns in an effort to channel investments into the industrial sector. Fforde, *Competition, Innovation and Regulation in British Banking*, 23 BANK ENG. Q. BULL. 363 (1983); Redsløb, *Le Centre Financier International de Londres - I. La Mutation*, 1977 BANQUE 667.

a whole. Following this "Life Boat" operation, ratio controls were applied to all banks, including the secondary banks, lending ceilings were abolished and many of the clearing banks' longstanding agreements (including the interest rate cartel) were abandoned.<sup>10</sup>

### 2.1.2. *Building Societies*

During the industrial revolution, mutual building societies were formed to provide a mechanism for financing home purchases by workers. These societies also were designed as a government policy instrument for promoting private homeownership. They were not subject to deposit rate ceilings and enjoyed favorable tax treatment. Restrictions on the composition of building society assets, however, did not permit deposit account overdrafts. As a result, the societies were precluded from offering "checkable" current accounts, although the Building Societies Act permitted considerable latitude for diversification within the legal restrictions.<sup>11</sup>

By offering deposit facilities, a consumer-friendly service and an interest rate slightly higher than the one offered by the clearing banks' cartel, the building societies gradually took on the function of holding individual savings, even though the operational distinctions between them and the clearing banks remained clear. From the early 1980s on, however, the banks and the building societies have been in more direct competition with each other. Banks started offering home mortgages, which had been the traditional preserve of the building societies, and the building societies reacted by getting involved in various fields including savings schemes and automated teller machines.<sup>12</sup>

These developments called into question the degree of specialization between banks and building societies in providing retail deposits. A wider diversification, sought on behalf of the building societies, raised the issue of the need for different forms of prudential control as well as the potential need to change from mutual society to company status. Proposals for the legislative reform of building societies were therefore

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10. See Redslob, *Le Centre Financier International de Londres - 2. L'incertitude*, 1977 BANQUE 837; D'Havé & Quintyn, *supra* note 1, at 99-100; Gardner, *supra* note 8, at 7.

11. Jones, *The Future of Building Societies*, NAT'L WESTMINSTER BANK Q. REV., May 1984, at 33; see Northedge, *Building Societies at the Starting Gate*, 137 THE BANKER, Jan. 1987, at 30; D'Havé & Quintyn, *supra* note 1, at 98.

12. COMMITTEE TO REVIEW THE FUNCTIONING OF THE FINANCIAL INSTITUTIONS, REPORT AND APPENDICES, 1980, CMND., NO. 7937, at 247; H. MCRÆ & F. CAIRNCROSS, CAPITAL CITY: LONDON AS A FINANCIAL CENTRE 21-32 (rev. ed. 1985); Governor of the Bank of England, *The Future of the Building Societies: A Central Banker's View*, 23 BANK ENG. Q. BULL. 216 (1983).

limited to emphasizing the extension of the building societies' powers to offer a full range of services, including insurance broking, to house purchasers/owners rather than the extension of their powers within the banking sector. These proposals ultimately reemerged in a refined form in a Government green paper that formed the basis for the Building Societies Act 1986.<sup>13</sup>

### 2.1.3. *The Stock Exchange*

The British Stock Exchange was organized in terms of a strict separation of power between brokerage firms and dealers or so-called jobbers. The brokers acted as agents for investors, arranging deals on their behalf with jobbers for a minimum fixed commission. Brokers were able directly to put through matched trades, but jobbers needed to check the price before the trade could be completed and the transaction had to take place through the jobbers' book. Brokers also managed investment portfolios and provided investment advice.<sup>14</sup> The market itself was composed of competing market makers or jobbers on the floor of the Exchange. The jobber system was highly concentrated, and only limited information was available on jobbers' quotes and the prices at which deals were struck. Such limited disclosure of information on prices was regarded as an important protection for the jobbers and hence for the liquidity of the market.<sup>15</sup> Member firms were known to have only modest capital in comparison with firms in some foreign markets. While there were no statutory restrictions on cross-ownership of banks and securities firms and although banks had long been active in Eurodollar issues, the stock exchange rules, especially the ownership rules, effectively formed a barrier for sterling issues.<sup>16</sup>

### 2.2. *The Regulatory Structure in the United Kingdom*

The supervision or prudential regulation of banks was never an area of major importance in British banking, and it hardly existed as a bank

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13. See 47 Wash. Fin. Rep. (BNA) 516, 517 (1986); *Building Societies Given Greater Scope to Diversify*, Fin. Times, March 12, 1987, at 7; Brennan, *Home Loan Giants Look Up From Their Knitting*, EUROMONEY, Jan. 1987, at 104; Hague, *Facing Up to a Cultural Challenge*, Fin. Times, Jan. 9, 1987, at 32; Governor of the Bank of England, *supra* note 12, at 218-19; Jones, *supra* note 11, at 43; Gardener, *supra* note 8, at 11.

14. H. McRAE & F. CAIRNCROSS, *supra* note 12, at 137-39; Jackson, *Changes in the Stock Exchange and Regulation of the City*, 25 BANK ENG. Q. BULL. 544, 545 (1985).

15. Jackson, *supra* note 14, at 545.

16. Deputy Governor of the Bank of England, *Changes in the Structure of the Financial Markets: A View From London*, 25 BANK ENG. Q. BULL. 75 (1985).

regulatory function before the secondary banking crisis. The concentrated nature of the industry and its overall stability created the perception that no explicit legislation was necessary. The result was a system of "moral suasion"—informal discussions with a bank's management and general suggestions by the Bank of England addressed to the banking community. The existing supervision was focused on the Bank's operational role as a central bank. Therefore, the system was almost exclusively concerned with "supervising" members of the discount market and accepting houses, which were prepared to accept the Bank's supervision in exchange for a special market relationship with it.<sup>17</sup>

In August 1974, following the "Life Boat" operation, a voluntary system for nearly all deposit takers was put in place, but it was questionable whether the system would continue to work once the crisis ended. Following a Government white paper entitled "Licensing and Supervision of Deposit Taking Institutions," legislative action was undertaken, and the result was the Banking Act 1979. This Act was intended to put the Bank involvement in industry supervision, which had resulted from a spontaneous reaction to the crisis, on a statutory footing.<sup>18</sup>

The Banking Act 1979 granted supervisory authority to the Bank of England over all deposit taking institutions with the exception of the building societies. The institutions involved were required to meet minimum managerial and financial requirements and to file periodic statements of condition with the Bank.

At the same time, the Banking Act 1979 reinstated the traditional distinction between clearing banks and licensed deposit takers. The Act allowed the Bank of England to continue its close relationship with the major banks while also giving it greater control over the licensed deposit takers. The Bank could thus maintain its basic philosophy of flexibility in banking supervision and handle the day-to-day fulfillment of its supervisory role without recourse to detailed legal provisions.<sup>19</sup>

Although the Banking Act 1979 did not prove wholly satisfactory, once again it took a crisis to make legislative change a high priority. In 1984, the Bank of England was forced to take over the banking interests of bullion dealer Johnson Matthey to save it from collapse. Many of the shortcomings that were demonstrated by this incident had already been identified, but the Bank was unable to remedy them with-

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17. Deputy Governor of the Bank of England, *Supervision and Central Banking*, 27 BANK ENG. Q. BULL. 380 (1987); Gardener, *supra* note 8, at 6.

18. Deputy Governor of the Bank of England, *supra* note 17, at 381.

19. See Cooke, *The Role of the Banking Supervisor*, 22 BANK ENG. Q. BULL.

out new legislation.<sup>20</sup>

The Government established a committee under the chairmanship of the Governor of the Bank of England to consider any necessary changes in the existing regulatory system.<sup>21</sup> The committee's report was published in June 1985 and made a number of recommendations aimed at strengthening the existing system.<sup>22</sup> A Government white paper, issued after extensive deliberation, endorsed most of the suggestions that had been made in the committee report. The resulting legislation designated the Bank of England as the supervisory authority for banks, and a Board of Banking Supervision was to be established within the Bank in order to assist Governor in the performance of his supervisory duties.<sup>23</sup>

In the Bank opinion, the committee report and the White Paper did not involve a fundamental change in the approach to banking supervision in the United Kingdom. The intention was rather to tackle a number of weaknesses which had become apparent both in the present statutory framework and in its implementation.<sup>24</sup>

The Banking Act 1987 generally retains the system established under the 1979 Act, but it abolishes the two tiered structure. All institutions are now referred to as "authorised institutions" that are defined in terms of "deposit" and "deposit taking business." The 1987 Act prohibits the acceptance of deposits in the United Kingdom in the course of

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20. The Bank of England's Supervision Department had failed to pick up the weakness of Johnson Matthey's loan portfolio and to warn the Bank of the scope of its problems when it took over. H. MCRAE & F. CAIRNCROSS, *supra* note 12, at 238; Deputy Governor of the Bank of England, *Responsibilities of the Private and Public Sectors*, 24 BANK ENG. Q. BULL. 500 (1984); BANK OF ENGLAND, 1985 REPORT AND ACCOUNTS 32; Governor of the Bank of England, *The UK Approach to Financial Regulation*, 26 BANK ENG. Q. BULL. 48, 50 (1986); Blanden, *UK Supervision: What Banks Have To Do*, 137 THE BANKER, Apr. 1987, at 49.

21. BANK OF ENGLAND, 1985 REPORT AND ACCOUNTS 37.

22. REPORT OF THE COMMITTEE SET UP TO CONSIDER THE SYSTEM OF BANKING SUPERVISION, 1985, CMND., No. 9550.

23. BANK OF ENGLAND, 1986 REPORT AND ACCOUNTS 41; HER MAJESTY'S TREASURY, BANKING SUPERVISION REPORT, 1985 (Cmd. 9695). A banking bill, designed to provide a statutory basis for the "important regulatory improvements" which were identified in the White Paper was published on November 14, 1986. The Government further announced that it had decided to set up, in cooperation with the Bank of England, an independent review of the law relating to banking mechanisms and practices. 47 WASH. FIN. REP. (BNA) 949 (Dec. 15, 1986).

24. The Bank of England has intensified its program of supervisory visits. However, there is a need for adequate powers to be available to supervisors to deal with those cases in which voluntary cooperation is not forthcoming. There is also a need to increase the commercial experience of the supervisors in order to improve their capacity to reach informed judgments on the banks they are supervising. BANK OF ENGLAND, 1986 REPORT AND ACCOUNTS 41-43; Deputy Governor of the Bank of England, *Supervision and Competitive Conditions*, 26 BANK ENG. Q. BULL. 242 (1986).



carrying on a deposit-taking business without the authorization of the Bank of England. In light of the wide scope of this prohibition — it extends beyond those institutions which might commonly be regarded as “banks” to encompass institutions which finance their own businesses materially from deposits or from the interest earned on them — it was necessary to provide for numerous exemptions.<sup>25</sup>

These exemptions are provided for under clause 4 of the Act, and the general policy has been to grant exemptions where appropriate safeguards to the depositors are in place. To improve the effectiveness of the Act, clause 7 empowers the Treasury, in consultation with the Bank, to amend the definitions of “deposit” and “deposit taking” by secondary legislation in order to take into account developments in the financial market.<sup>26</sup>

Instead of separating the supervisory functions from the other central bank functions, as had been suggested in the Government White Paper, the Board of Banking Supervision was created to advise the Bank on broad issues involving supervision of the authorized institutions. Therefore, the Bank Supervision Division has been reinforced. Under the 1987 Act, the Bank has the power to revoke or restrict authorization, to regulate invitations for deposits, to require information and documents from authorized institutions, to order investigations and to compel an authorized institution to provide it with such information as the Bank may reasonably require for the performance of its functions under the Act.<sup>27</sup> There will also be a significant increase in the role of auditors in monitoring and reporting on the systems established by banks to ensure appropriate accounting for their activities.<sup>28</sup>

The Building Societies Act 1962 gave responsibility for prudential supervision of building societies to the Chief Registrar of the Friendly Societies. The Chief Registrar promulgated regulations specifying which liquid assets the societies were allowed to hold, mostly short and medium term stock issued by the Government or by local authorities.<sup>29</sup>

Following the proposals for reform aimed at making the building societies more competitive with banks by enlarging their powers, the Building Societies Act 1986 was enacted. This Act has changed the regulatory structure of the societies by conferring regulatory powers over them to a new Building Societies Commission. The Commission had to

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25. See Lewis, *The Banking Bill: Between Charybdis and Scylla*, 2 J. INT'L BANKING L. 49 (1987).

26. See *id.* at 53.

27. Lickorish, *A Practitioner's Guide to The Banking Act 1987*, 6 INT'L FIN. L. REV., Nov. 1987, at 27-28.

28. Blanden, *supra* note 20, at 49.

29. See Brennan, *supra* note 13, at 104.

publish new proposals on capital adequacy after its original proposal had been attacked by the societies as too cautious, because it would have left the societies with insufficient financial resources to take advantage of their new powers under the Act.<sup>30</sup>

The regulatory structure of the securities industry was based on the Prevention of Fraud (Investments) Act 1958 ("PFI Act").<sup>31</sup> Under the PFI Act, the Department of Trade and Industry would issue Conduct of Business Rules to be applied to recognized dealers.<sup>32</sup> However, the narrow definition of securities under the PFI Act and the exclusion of investment advisers from its field of application led to gaps in its coverage. The majority of the firms involved in the securities industry were exempt from the need to obtain a license because of their membership in the Stock Exchange or in one of the eight associations of securities dealers recognized by the DTI. The PFI Act further provided for the exemption of institutions which dealt only incidentally in securities, and most banks were able to benefit from the exemption by successfully establishing that dealing in securities was only ancillary to their principal business. The Bank of England never regulated the banks' activities as issuing houses, fund managers or investment advisers other than to ensure that they maintained their overall solvency.<sup>33</sup>

30. See sources cited *supra* note 13.

31. The Prevention of Fraud (Investments) Act 1958 ("PFI Act"), however, is not the only existing form of statutory regulation: the Companies Act 1980 contains prospectus requirements, corporate disclosure rules and rules making insider trading a criminal offense. In addition, the Industrial and Provident Societies Acts, the Building Societies Act, the Banking Act 1979, the Insurance Companies Acts, the Policy Holders' Protection Act 1975 and the Insurance Brokers (Registration) Act 1977, all contain some provisions regulating the marketing of securities. L.C.B. GOWER, REVIEW OF INVESTOR PROTECTION: A DISCUSSION DOCUMENT §§ 3.11-3.26 (1982) [hereinafter DISCUSSION DOCUMENT]. This statutory regulation is supplemented by non-statutory regulation. The Stock Exchange regulates the principal market in securities. *Id.* § 3.22. The Panel on Take-Overs and Mergers administers the City Code on Take-Over and Mergers. *Id.* § 3.27. The Council for the Securities Industry ("CSI") acts as the coordinator of the self-regulatory bodies of which it is composed. *Id.* § 3.29. The City Code and the Panel on Take-Overs and Mergers has no statutory backing, and the Panel's authority rests on the acceptance of its rulings by the general financial community and by the associations which make up its membership. McKenna, *The Gower Report - A British SEC?*, 2 INT'L FIN. L. REV., Aug. 1983, at 28.

32. In 1983, new Licensing Dealers (Conduct of Business) Rules were promulgated, and the Department of Trade and Industry ("DTI") took a tougher line on the licensing of dealers. Pimlott, *The Reform of Investor Protection in the U.K.: An Examination of the Proposals of the Gower Report and the U.K. Government's White Paper of January, 1985*, 7 J. COMP. BUS. & CAP. MARKET L. 141, 151 (1985); L.C.B. GOWER, REVIEW OF INVESTOR PROTECTION: REPORT, PART I, 1984, CMND., NO. 9125, §2.03 [hereinafter GOWER REPORT].

33. DISCUSSION DOCUMENT, *supra* note 31, § 9.08, Jackson, *supra* note 14, at 548; Pimlott, *supra* note 32, at 143.

### 3. THE REGULATORY FRAMEWORK EMERGING AFTER THE ENACTMENT OF THE FINANCIAL SERVICES ACT 1986

#### 3.1. *Market Restructuring*

The narrow scope of the PFI Act, the widely used possibility of obtaining the status of an exempted dealer, and the lax enforcement of the DTI all pointed towards the need for a comprehensive review of investor protection. This was further highlighted by certain scandals that occurred during 1981. In response, the Government commissioned Professor L.C.B. Gower to review the existing system of investor protection.<sup>34</sup>

This review of investor protection occurred at a time of great change in the British securities markets. Due to the internationalization of these markets, the members of the London Stock Exchange had to compete at the international level. Although valuable to the position of individual Exchange members, central elements of the Stock Exchange rule book, such as the minimum-fixed commissions, the single capacity system, and the ownership rules, were also responsible for the low capitalization of the Exchange members, which in turn led to their inability to compete with foreign firms.<sup>35</sup>

Although many members of the Exchange had long recognized the need to adapt to meet the various international challenges, no action had been taken because of a peculiar set of circumstances. Following the extension of the Restrictive Trade Practices Act 1976 to cover agreements relating to the provision of services, the Stock Exchange registered its rule book as an agreement and the Office of Fair Trading challenged the validity of this rule book under the Act. Professor

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34. In February 1981, the investment management company Norton Warburg collapsed with a deficit of some 2.5 million pounds, causing significant losses of money by individual investors. The money had been invested in Norton Warburg's own group of companies, which subsequently failed. Also, in March, the Stock Exchange had to appoint a Committee of Investigation to conduct an inquiry into a stockbrokerage firm in Manchester. Both cases involved conflicts of interest relating to investment management, but the 1960 Licensed Dealers (Conduct of Business) Rules did not have provisions requiring only disclosure. Once a firm had been licensed (as in the Norton Warburg case), the customers would have very little protection. Pimlott, *supra* note 32, at 146; Jackson, *supra* note 14, at 548; Wilkinson, *Surveillance and Compliance*, in *THE CITY AFTER THE FINANCIAL SERVICES ACT: A FINANCIAL TIMES CONFERENCE* § 7.1 (1986). For a discussion of the regulatory system as laid down in the PFI Act, see *DISCUSSION DOCUMENT*, *supra* note 31, §§ 3.01-3.10. For a discussion of the defects of the regulatory system, see *id.* §§ 5.01-5.17 (mentioning the limited scope of the system, the widely abused possibility of obtaining the status of an exempted dealer, the lax enforcement policy, and the failure of the system to achieve the proper balance between government regulation and self-regulation); see also, Stoakes, *The London Stock Exchange in Transition*, 2 INT'L FIN. L. REV., Dec. 1983, at 12.

35. Stoakes, *supra* note 34, at 12.

Gower's Discussion Document contained critical language with regard to the self-regulatory powers of the Stock Exchange. Although it seems a little extreme to read this as a proposal to eliminate the self-regulatory powers of the Stock Exchange, it is possible that in light of these comments, the Stock Exchange was not willing to consider changes in its rule book since such consideration might have weakened its position.<sup>36</sup>

Ultimately, the restrictive practices case was settled out of court. In the so-called Goodison-Parkinson Agreement, the Government agreed to drop the case before the Restrictive Practices Court in exchange for the Stock Exchange agreeing to dismantle the minimum commissions by stages. However, the Stock Exchange did not promise to change its dealing system or its membership arrangements. For a time, the maintenance of the single capacity scheme and the retention of the membership system were considered true possibilities.<sup>37</sup>

It was by no means certain that single capacity could actually work without fixed commissions. The reason why minimum commissions were first introduced in London was explicitly because the single capacity system had proved unworkable without them.<sup>38</sup> Enough people believed in this "link-argument" for the Stock Exchange to come to the conclusion that a dual capacity system had to be introduced with the abolition of fixed commissions. However, a dual capacity system would increase the need for member firms to have free access to outside capital and in turn force the Stock Exchange to change the ownership rules.<sup>39</sup> Therefore, as of March 1, 1986, a single non-member was allowed to own 100 percent of a member firm, but all Stock Exchange members had to remain separately capitalized entities within any wider grouping and the moratorium on the creation of new member firms with outside financing was lifted. Dual capacity dealing by Stock Exchange members in non-U.K. stocks has been allowed since April 1984, when the Stock Exchange removed the minimum commission schedules for deals

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36. See Pimlott, *supra* note 32, at 151; Stoakes, *supra* note 34, at 12; Jackson, *supra* note, 14, at 546.

All important will be the reaction of The Stock Exchange. It would wreck any prospect of proceeding on these lines if it maintained the view that its members must continue to be left to the exclusive control of the Exchange and that the Exchange must continue to be free from any Governmental supervision however residual.

DISCUSSION DOCUMENT, *supra* note 31, § 7.11.

37. See Stoakes, *supra* note 34, at 12-13; see also Pimlott, *supra* note 32, at 152.

38. I. KERR, *BIG BANG* 30-34 (1986).

39. Boudrillon, *Le Big Bang - Révolution ou Déroute?*, 1986 *BANQUE* 1068, 1069-70; Jackson, *supra* note 14, at 546; Deputy Governor of the Bank of England, *supra* note 16, at 77.

in overseas securities. The same arrangement has been applied to U.K. securities themselves since October 27, 1986, the date of "Big Bang."<sup>40</sup>

Dual capacity, negotiated commissions, and automatic quotations all forced market participants to reinforce their capital structure, link up with the quotation system and reorganize their trading teams. In this restructuring, one could opt for a financial conglomerate in the underlying belief that the future belongs to those firms that can simultaneously offer issuing, underwriting, dealing and distribution, or one could believe in the viability of traditional functions within the new market and decide to remain independent. Finally, a firm could decide to wait and see in the belief that once single capacity is removed, there will be a necessary shake-up in light of the number of new entrants.<sup>41</sup>

Just as this diversification raised organizational questions for the individual firms, it also raised questions about the organization of the regulatory structure, already under review by Professor Gower, because of its ineffectiveness. The removal of barriers between types of businesses that had traditionally been kept separate increased the scope of conflicts of interest. These issues needed to be addressed in the Gower review and the ensuing legislation.

### 3.2. Professor Gower's Proposals

Following a series of informal discussions with a number of professional bodies and individuals, Professor Gower published a Discussion Document.<sup>42</sup> In light of the changes in the securities industry over the past fifty years and the defects of the existing regulatory system, he was convinced of the need for a redistribution of responsibilities between governmental regulators and self-regulatory bodies (and between statutory and non-statutory regulation).<sup>43</sup> Having reviewed the relative advantages and disadvantages of both self-regulation and governmental regulation, Professor Gower came up with five possible lines of reform but he retained only the fifth as feasible: "[i]t should be the role of government to decide major questions involving public policy but discretionary day to day regulation is better handled by self-regulatory agencies."<sup>44</sup>

40. Ingram, *Change in The Stock Exchange and Regulation of the City*, 27 BANK ENG. Q. BULL. 54 (1987); Jackson, *supra* note 14, at 546-47.

41. See *The City of London: What Went Wrong in Learning to Manage - A Survey of the City of London*, THE ECONOMIST, June 25, 1988, at 3-11.

42. See DISCUSSION DOCUMENT, *supra* note 31, §§ 1.02-1.04.

43. *Id.* § 5.17.

44. The other alternatives were: (1) retention of the status quo; (2) revision of the PFI Act (this was rejected since it would not reduce government involvement and instead it would increase the work load of civil servants in day-to-day regulation); (3)

This adjusted balance between governmental regulation and self-regulation could not be implemented immediately. There were not enough self-regulatory organizations ("SROs") to cover all the fields. Even the most respected SROs had not thoroughly adjusted their constitution and rules in recognition of their public role,<sup>45</sup> and the existing SROs did not operate within a comprehensive statutory framework in which the Government performed only supervisory or residual roles.<sup>46</sup> Professor Gower proposed for discussion a new regulatory framework of four self-regulatory agencies based on functional lines: one for the dealings on the Stock Exchange; one for the dealings of the Stock Exchange and investment management advice; one for unit trusts; and a Take-Over and Issues Agency. The existing Council for the Securities Industry ("CSI")<sup>47</sup> was suggested as an "umbrella body" to coordinate and supervise the new agencies.<sup>48</sup> The proposed regulatory framework would break down in this way:

### NEW SECURITIES ACT GOVERNMENT

Public Issues and  
Take-Over Agency

The Stock Exchange

An amalgam of the Take-Over Panel and the Quotations Department of the Stock Exchange, it would be responsible for prescribing the contents of and scrutinizing prospectuses in respect to listed and unlisted securities, whether or not in connection with a take-over.

It would remain responsible for the regulation of the central market of the Stock Exchange and stock broking and jobbing operations of its member firms.

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coordination of the PFI Act with other controls (this was rejected since it would do nothing to establish a more coherent and better balanced relationship between government regulation and self-regulation); (4) establishment of a Securities Commission (this was rejected since the Government did not want another "QUANGO" or Quasi Autonomous Non-Governmental Organization and since the City objected to it). *Id.* §§ 7.02-7.09.

45. *Id.* § 7.10.

46. *Id.*

47. See Stoakes, *supra* note 34, at 12.

48. DISCUSSION DOCUMENT, *supra* note 31, § 8.22.

## CSI

## The Third Agency

## Unit Trust Agency

An unspecified body that would be responsible for the regulation of over-the-counter markets, dealings off the Stock Exchange, and investment advice.

It would regulate all unit trusts and other mutual funds and would prescribe what types of trusts would be allowed to market units and how.<sup>49</sup>

Under Professor Gower's proposals, a Securities Act would replace the PFI Act and include redrafted provisions, at that time found in the Companies Act, relating to the issuing and distribution of securities. It would be an offense to carry on unregistered business in securities. Securities would be defined broadly but as clearly as possible.<sup>50</sup> Registration would be through membership in or registration with an appropriate self-regulatory agency recognized by the DTI.<sup>51</sup>

This "ideal" system was primarily concerned with the regulation of securities dealings. Professor Gower saw no reason to disturb the present regulation of banking or deposit-taking as such.<sup>52</sup> Although he pointed out that banks would "of course" be affected by any new securities legislation in so far as they carried on business as issuing houses, fund managers or investment advisers,<sup>53</sup> no attempt was made to deal with this overlap in regulatory powers.

Although the City institutions generally accepted the urgent need for a new Securities Act, most of the responses published by bodies representing City institutions were hostile to Gower's other conclusions.<sup>54</sup> A number of responses urged "that it would not be practicable to establish self-regulatory agencies based, as the Discussion Document [had] suggested, on a functional division of investment business, but that, in light of the way in which the investment industry had developed, they would have to be based instead on its present professional

49. McKenna, *supra* note 31, at 30.

50. DISCUSSION DOCUMENT, *supra* note 31, § 8.02.

51. *Id.* § 8.03.

52. Professor Gower did, however, suggest the removal of an overlap which existed between licensing under the PFI Act and licensing under the Banking Act 1979 when a securities dealer benefited from the use of a client's money. According to Gower, this came under the definition of a deposit-taking activity as defined in the Banking Act 1979. *Id.* §§ 3.14, 9.07.

53. Under the PFI Act, banks engaged in these activities as exempted dealers are not subject to the Conduct Rules issued by the DTI. See *supra* note 33 and accompanying text.

54. McKenna, *supra* note 31, at 31.

and commercial groupings.<sup>55</sup> Notwithstanding the fact that these criticisms attacked some of the basic elements of the proposed regulatory structure, Professor Gower, in his Final Report published in January 1984, claimed that the responses to his Discussion Document revealed a clear consensus in favor of a comprehensive system of regulation within a statutory framework primarily based on self-regulation subject to Government surveillance.<sup>56</sup>

### 3.3. *The DTI White Paper and the Financial Services Bill*

Although the debate on how best to regulate the securities industry intensified following the publication of Professor Gower's Final Report, by mid-1984 the focus of the debate had begun to shift away from the issues of controlling investment managers and advisers to the question of how to control conflicts of interest across a much broader area.<sup>57</sup> This concern arose out of the realignments among banks, stock brokers, investment managers, discount houses and others in the London financial community that were brought about by the prospect of the end of minimum commissions.<sup>58</sup> When the industry could not agree on the role to be performed by the CSI, the Governor of the Bank of England asked an advisory group under the chairmanship of Sir Martin Jacomb to come forward with proposals of its own. Although the report of this advisory group was never published, it is said that its content may be gleaned from the DTI's 1985 White Paper on financial services in the United Kingdom.<sup>59</sup> Following Professor Gower's proposals, the DTI wanted its regulatory system to be one of self-regulation within a statutory framework.<sup>60</sup> However, contrary to what Professor Gower had proposed, the DTI wished to place the responsibility for authorizing investment businesses upon one or more private sector bodies.<sup>61</sup> Such

55. *Id.*; GOWER REPORT, *supra* note 32, § 2.04.

56. GOWER REPORT, *supra* note 32, § 203.

57. Pimlott, *supra* note 32, at 159.

58. *See supra* note 40 and accompanying text.

59. Governor of the Bank of England, *The Future of the Securities Market*, 24 BANK ENG. Q. BULL. 189, 193 (1984); Bertill, *Regulation in a Changing City - Bureaucrats and Practitioners*, MIDLAND BANK REV., Summer 1986, at 16. The Government published its proposals for a new system of regulation for the financial services industry of the United Kingdom in a "White Paper". DEPARTMENT OF TRADE AND INDUSTRY, FINANCIAL SERVICES IN THE UNITED KINGDOM: A NEW FRAMEWORK FOR INVESTOR PROTECTION, 1985 (Cmd. 9432) [hereinafter WHITE PAPER]; *see generally* Abrams, *The Financial Services White Paper: A Legal Analysis*, 6 THE COMPANY LAW. 77, 77-81, 122-26 (1985) (evaluating the DTI's proposals).

60. WHITE PAPER, *supra* note 59, § 5.1.

61. The industry had expressed a preference for

a board composed of practitioners and lay members, exercising powers transferred by Government but not part of Government, taking on the role



body or bodies would have to be developed while legislation was under consideration in Parliament, therefore allowing delegation of authority once the legislation was enacted.<sup>62</sup> The DTI made clear that it was prepared to accept a single body if the financial services industry and its customers would conclude that there were advantages in a single body, but it believed that an effective system could be based on two bodies.<sup>63</sup> For convenience, these bodies were referred to as a Securities and Investments Board and a Marketing of Investments Board.<sup>64</sup> Although the very important contributions made to self-regulation by the Stock Exchange and other bodies were recognized, it was made clear that the new structure would be function-based.<sup>65</sup> Recognizing that there would be overlapping regulatory responsibilities,<sup>66</sup> the DTI insisted that the need for multiple authorization of investment business should be kept to a minimum. To facilitate cooperation between the various regulatory bodies, it proposed enabling "information to be transferred between regulators, subject to necessary safeguards."<sup>67</sup>

The DTI White Paper left a great many questions unanswered. It was clear that banks would no longer be able to enjoy the status of exempted dealer and that they would come under the new regulation. However, the role of the Bank of England within this new framework was unclear.<sup>68</sup>

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that Professor Gower had envisaged for the free-standing agency/commission. The essence of this body however, would be the strong practitioner element on its board, and the private status that would permit it a freer hand than would otherwise be the case in securing the staff and other resources necessary to do a proper job.

Berrill, *supra* note 59, at 16. The fact that the Secretary of State had also been "influenced" by a second advisory group (formed by the chairman of the Life Offices Association) probably explains why the White Paper proposed *two* bodies sitting at the top of the regulatory pyramid.

62. The Government would seek Parliamentary approval for regulatory powers to be given to the Secretary of State, who would be enabled to delegate these powers to anyone who appeared to meet the criteria set out in the legislation. This designated body would be able to recognize self-regulatory organizations ("SROs") and have authority over their rules and practices. WHITE PAPER, *supra* note 59, §§ 5.8-5.9.

63. *Id.* § 5.3.

64. *Id.*

65. *Id.* § 5.4.

66. Such overlaps have been described as "not a new phenomenon to which recent developments were likely to give greater significance." *Id.* § 5.13.

67. *Id.*

68. Abrams, *supra* note 59, at 77. One of the major problems of the White Paper and the Financial Services Bill was the failure to recognize the Euromarket as a separate entity in need of a different form of regulation. The initial reaction of the Euromarket was that since it did not deal with the British public, and its market had been free from scandal, the whole thing had nothing to do with them. The Bank of England, however, soon made it clear that exclusion from the first draft of the Bill did not mean similar freedom from the new laws. Why Us?, EUROMONEY, Big Bang Sup-

Before the Financial Services Bill was introduced in Parliament, the Secretary of State for Trade and Industry set up the Marketing of Investment Board Organizing Committee ("MIBOC") in March 1985 and the Securities and Investment Board ("SIB" or "the Board") in June 1985. From the very beginning, SIB and MIBOC worked closely together and decided in mid-1986 to merge into the present Securities and Investment Board, agreeing that it would be more effective to have one overall body.<sup>69</sup>

The Financial Services Bill was published in November 1985. As could have been expected, it went through a lengthy committee stage where it was subjected to a number of amendments from two opposing lobbies. Whereas the consumer lobby took the point of view that the Bill did not go far enough, the industry lobby undertook every possible effort to curb the scope of the Bill.<sup>70</sup>

### 3.4. *The Financial Services Act 1986 - Delegation of Regulatory Powers to a Designated Agency*

The Financial Services Act ("the Act") ultimately received Royal Consent on November 7, 1986. Its 212 articles and 17 schedules form a 289-page document entitled: "An Act to regulate the carrying on of investment business, to make related provisions with regard to insurance business and business carried by friendly societies; to make provisions with respect to the official listing of securities, offers of unlisted securities, take-overs and insider trading; to make provisions as to the disclosure of information obtained under enactments relating to fair trading, banking and insurance; to make provisions for securing reciprocity with other countries in respect of facilities for the provisions of financial services; and for connected purposes." Most interesting to the present discussion is the regulation of investment business as provided

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plement, Aug. 1986, at 27; Jackson, *supra* note 14, at 550. In a defensive action, the Euromarket created the International Securities Regulatory Organization ("ISRO") to become an SRO and to protect the Euromarket's interests as the new regulation took shape. I. KERR, *supra* note 38, at 85; Governor of the Bank of England, *supra* note 20, at 49; *World Welcomes Watchdogs*, EUROMONEY, June 1986, at 87; Agnew, *Capital Adequacy*, in *THE CITY AFTER THE FINANCIAL SERVICES ACT: A FINANCIAL TIMES CONFERENCE* § 6.1 (1986).

69. SECURITIES AND INVESTMENTS BOARD, *FINANCIAL SERVICES: A GUIDE TO THE NEW REGULATORY SYSTEM* 4 (1986); McDougall, *Control & Conflict*, 136 *THE BANKER*, Apr. 1986, at 32-33. While the Financial Services Bill was under consideration, SIB started working on rules and sent out consultation documents in the form of detailed papers. For an overview, see Blanden, *Big Bang*, 136 *THE BANKER*, Oct. 1986, at 31.

70. Morris, *Financial Services Act: What It Means for Banks*, 2 *J. INT'L BANKING L.* 147, 148 (1987).

for in Part I of the Act.

In regulating "investment business" rather than "investment institutions," the Act introduces an entirely new regulatory structure which covers fields in which both clearing banks and building societies had been increasingly extending their activities. As could have been expected following Professor Gower's proposal and the DTI White Paper, the definitions of what constitutes "carrying on investment business" are extremely wide, although it is considered implicit that in order to amount to "investment business" the investment activities (as listed in Schedule 1 to the Act) must be frequent enough and have the necessary characteristics to be viewed as business transactions. Escape routes that exist in that regard will most likely not be available, however, to most financial institutions including clearing banks and building societies, because the exceptions were intended to remove marginal cases from the ambit of the Act.<sup>71</sup>

The breadth of the definitions used in the Act will thus result in the new regulatory structure having an impact on the entire United Kingdom financial services industry. Firms active in this industry will, pursuant to Sections 3 and 4 of the Act, have to become either an *authorized person* under Chapter III of the Act or an *exempted person* under Chapter IV of the Act.

Under Chapter III of the Act, an individual is an authorized person if he is a member of a recognized self-regulatory agency<sup>72</sup> or if he is certified by a recognized professional body.<sup>73</sup> There are special provisions for insurance companies,<sup>74</sup> friendly societies<sup>75</sup> and collective in-

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71. *Id.* at 147-49.

72. A recognized self-regulatory body is defined as a body which regulates the carrying on of investment business of any kind by enforcing rules which are binding on persons carrying on business of that kind either because they are members of that body or because they are otherwise subject to its control. Financial Services Act, 1986, ch. 60, § 9.

73. A recognized professional body ("RPB") is defined as a body which regulates the practice of a profession, and references to the practice of a profession do not include reference to carrying on a business consisting wholly or mainly of investment business. Financial Services Act, 1986, ch. 60, § 16(1). This provision provides a regulatory structure for the investment business (mostly investment advice) conducted by solicitors and accountants. Their professional bodies can seek recognition as regulators. However, the SIB expects the RPBs to regulate investment business carried on only in the course of or in conjunction with the practice of the profession while non-incident business is to be regulated by an appropriate SRO or by the SIB itself. SECURITIES AND INVESTMENTS BOARD, SIB'S APPROACH TO ITS REGULATORY RESPONSIBILITIES (AN ADDITIONAL STATEMENT SUBMITTED TO THE SECRETARY OF STATE AS A SUPPLEMENT TO THE DRAFT RULES AND REGULATIONS) 43 (1987) [hereinafter ADDITIONAL STATEMENT].

74. Since insurance companies are subject to the Insurance Companies Act 1982, there is no need for authorization if they conduct no other investment business or do not violate § 16 of the Insurance Companies Act. Financial Services Act, 1986, ch. 60, §

vestment schemes.<sup>76</sup> A person can be authorized under the Act without being a member of a SRO or a professional body by obtaining the direct authorization of the Secretary of State.<sup>77</sup>

Exempted persons are the Bank of England,<sup>78</sup> the recognized investment exchanges,<sup>79</sup> clearing houses,<sup>80</sup> Lloyd's of London,<sup>81</sup> the money market institutions which are listed with the Bank of England (but only with regard to the activities mentioned in schedule 50 of the Act),<sup>82</sup> and the appointed representatives.<sup>83</sup>

The Act provides for the Secretary of State to write rules regulating the conduct of investment business by authorized persons. Those rules will not apply, however, to members of recognized self-regulatory organizations or persons certified by a recognized professional body with respect to the carrying on of investment business for which they are subject to the rules of the organization or body.<sup>84</sup>

Both the SROs and the professional bodies must be recognized by

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75. See Financial Services Act, 1986, ch. 60, § 23 (discussing the activities in Schedule 1 of the Friendly Societies Act 1974).

76. *Id.* § 24.

77. *Id.* § 25.

78. *Id.* § 35.

79. *Id.* § 36. The Financial Services Act distinguishes between the functions of market regulators and exchanges, whereas these functions had been jointly exercised by the Stock Exchange in the past. The difference between an exchange and an SRO is that an SRO authorizes and regulates firms and their conduct towards their clients, while an exchange regulates markets and the conduct of persons who use it toward each other. Grass, *Internationalization of the Securities Trading Markets*, 9 Hous. J. INT'L L. 17, 26 (1986).

80. Financial Services Act, 1986, ch. 60, § 38.

81. *Id.* § 42.

82. *Id.* § 43. This exemption is an example of attempts undertaken to minimize overlaps by adjusting the boundaries of supervisory responsibility. The wholesale money market would normally have fallen within the ambit of the Financial Services Act. However, the Bank of England had long overseen the conduct of business in foreign exchanges, bullion and wholesale banking on a non-statutory basis and is itself a major participant in this market, carrying on its daily operational function on behalf of the Government. In early 1986 it was decided that the Bank of England should remain responsible for the supervision of those markets, and the Financial Services Bill was amended to omit those transactions which will be supervised by the Bank. Galpin, *Keynote Address*, in *THE CITY AFTER THE FINANCIAL SERVICES ACT: A FINANCIAL TIMES CONFERENCE* § 4.2 (1986); Ingram, *supra* note 40, at 63.

83. Financial Services Act, 1986, ch. 60, § 44. Under the Financial Services Act, conduct of business rules apply to insurance companies and friendly societies only in respect of "marketing" policies and the management and marketing of pension funds, and the financial resources rules do not apply. SECURITIES AND INVESTMENTS BOARD, *THE SECURITIES AND INVESTMENTS BOARD'S APPLICATION FOR DESIGNATED AGENCY STATUS UNDER THE TERMS OF THE FINANCIAL SERVICES ACT AND THE REVISED RULE BOOK DATED FEBRUARY 1987: EXPLANATORY STATEMENT* § 8 (1987) [hereinafter EXPLANATORY STATEMENT].

84. Financial Services Act, 1986, ch. 60, § 48(1).

the Secretary of State. The requirements for the recognition of SROs are in Schedule 2 of the Financial Services Act. These requirements provide explicitly that the rules and practices of the organization must ensure that its members are fit and proper persons to carry on investment business of the kind with which the organization is concerned. The recognition process also requires that the intra-organization rules provide the investor with protection at least equivalent to that afforded investors in investment businesses of the same kind directly authorized by the Secretary of State.<sup>85</sup>

Section 114 of the Act authorizes the Secretary of State to make an order to transfer all or any of the functions he has under Part I of the Financial Services Act to a corporate body<sup>86</sup> which is able and willing to discharge any of these functions and meets the requirements of Schedule 7 attached to the Act.<sup>87</sup> Under Section 114(2), however, the first order transferring these powers must be a transferral to the Securities and Investments Board, thereby making it the first designated agency. The Secretary can only transfer his functions if the designated agency has furnished him with a copy of the rules and regulations which it proposes to make in the exercise of those functions, if he is satisfied that those rules and regulations will afford investors an adequate level of protection and if the proposed order has obtained parliamentary approval.<sup>88</sup>

The key role in the whole regulatory structure will undoubtedly be played by the Securities and Investment Board. The SIB receives its powers from the Secretary of State for Trade and Industry, but this authority can also be withdrawn.<sup>89</sup> Sir Kenneth Berrill, the former Chairman of the SIB,<sup>90</sup> has made it clear that no one on the SIB is appointed to represent a particular interest or sector of the market.

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85. *Id.* sched. 2, § 3(1). Similar provisions are set forth in Schedule 3 with regard to the recognition of professional bodies.

86. *Id.* § 114.

87. Under Schedule 7, the designated agency must have adequate arrangements for the discharge of its functions, a satisfactory system of monitoring and enforcement, arrangements for investigation of complaints and arrangements for the promotion and maintenance of standards. *Id.* sched. 7.

88. *Id.* sched. 9, § 1.

89. The SIB is composed of persons with relevant business experience as well as those who are customers of investment business. *Id.* sched. 7, § 3.

90. On February 26, 1988, the DTI notified Berrill that he would not be reappointed as the chairman of the SIB. In May, Berrill was replaced by David Walker, who was formerly with the Bank of England and was one of the architects of Big Bang. Although the new appointment involves a man who was previously an executive in the industry which the SIB polices, the general opinion in the City is that Walker will be a forceful and consistent leader. See *Blame the Law, Not the Sheriff*, THE ECONOMIST, Mar. 5, 1988, at 19-20; *From Berrill Lynch to Slater Walker*, THE ECONOMIST, Mar. 5, 1988, at 81.

Berrill has stated:

Their background is important for the knowledge and experience that they can bring to bear on the problems that confront them as a board, [but] all of the Board's members must be independent and they must not under any circumstances, see themselves as appointed to argue the corner for the interests of their own firm or market.<sup>91</sup>

Several features were built into the regulatory structure in order to avoid undue influence by SROs on the SIB's rules:

- The Chairman of the Board and its members will be appointed by the Secretary of State and the Governor of the Bank of England.<sup>92</sup>
- The Secretary of State has the power to resume regulatory responsibility from the Board if it ceases to conform to the requirements set out in the legislation.<sup>93</sup>
- The Board is under an obligation to report annually to the Secretary of State who must submit these reports to Parliament.<sup>94</sup>
- The decisions of the Board on authorization of investment businesses and on disciplinary matters are referable to an independent tribunal appointed by the Lord Chancellor and the Secretary of State.<sup>95</sup>
- The Secretary of State is able to require the revocation or the amendment of the rules of the Board if they are contrary to the United Kingdom's international obligations.<sup>96</sup>
- After obtaining advice from the Director General of Fair Trading, the Secretary of State can require the Board to change or remove a rule if it is judged detrimental to competition to an extent unjustified by the requirements of investor protection.<sup>97</sup>

At the beginning of February 1987, the SIB officially requested the Secretary of State to make it the first designated agency under the Act and made its rulebook public. The rulebook was reviewed by the Secretary of State from the point of view of effective investor protection

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91. Berrill, *supra* note 59, at 16.

92. Financial Services Act, 1986, ch. 60, sched. 7, § 1.

93. *Id.* § 115.

94. *Id.* § 117.

95. *Id.* § 97(1).

96. *Id.* § 192(1).

97. *Id.* § 120.

and by the Director General of the Office of Fair Trading from the point of view of its impact on competition. This procedure ultimately resulted in the desired recognition being conferred on May 18, 1987.<sup>98</sup>

The DTI White Paper had suggested some possible SROs: The Stock Exchange,<sup>99</sup> the Association of Futures Brokers and Dealers ("AFBD"),<sup>100</sup> and the National Association of Securities Dealers and Investment Managers ("NASDIM").<sup>101</sup> However, not all investment businesses within reach of the Act were willing to obtain authorization from one or more of these bodies. As a result, the SIB and the MIBOC began talks with other organizations,<sup>102</sup> including the International Securities Regulatory Organization ("ISRO"),<sup>103</sup> the Investment Management Regulatory Organization ("IMRO"),<sup>104</sup> the Life Assurance and Unit Trust Regulatory Organization ("LAUTRO"),<sup>105</sup> and the

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98. EXPLANATORY STATEMENT, *supra* note 83, § 2; Ingram, *supra* note 40, at 62; Niyonzima, *The Supervision Over Investment Businesses in the United Kingdom Under the Financial Services Act (FSA) 1986*, 1987 REVUE DE LA BANQUE, No. 8, at 30.

99. Coverage: Firms dealing and broking in securities and related options and futures; investment management and advice incidental to this business. SECURITIES AND INVESTMENTS BOARD, REGULATION OF INVESTMENT BUSINESS: THE NEW FRAMEWORK 8 (1986) [hereinafter, THE NEW FRAMEWORK]; see ADDITIONAL STATEMENT, *supra* note 73, at 39; Ingram, *supra* note 40, at 64.

100. Coverage: Firms dealing and broking in futures and options; investment management and advice incidental to this business. THE NEW FRAMEWORK, *supra* note 98, at 8; see ADDITIONAL STATEMENT, *supra* note 73, at 40; Ingram, *supra* note 40, at 64.

101. Coverage: Firms dealing and broking in securities and collective investment products; investment managers and advisers. THE NEW FRAMEWORK, *supra* note 99, at 8; see ADDITIONAL STATEMENT, *supra* note 73, at 40; Ingram, *supra* note 40, at 64.

102. With a view to reducing potential overlap, the SIB and MIBOC encouraged LUTIRO and NASDIM to merge, resulting in the Financial Intermediaries Mangers & Brokers Regulatory Association ("FIMBRA"). THE NEW FRAMEWORK, *supra* note 99, § 1.12. ADDITIONAL STATEMENT, *supra* note 73, at 40; Ingram, *supra* note 40, at 64. This number was further reduced to five when the Stock Exchange and International Securities Regulatory Organization ("ISRO") merged into the Securities Association. ADDITIONAL STATEMENT, *supra* note 73, at 39; Ingram, *supra* note 40, at 55-56. The SIB has expressed the belief that together these five SROs should form a satisfactory structure, capable of providing for the whole range of investment business. ADDITIONAL STATEMENT, *supra* note 73, at 37; McDougall, *supra* note 69, at 33-34.

103. Coverage: Firms dealing and broking in securities, international money market instruments, forward agreements, and related futures and options. THE NEW FRAMEWORK, *supra* note 99, at 8; see ADDITIONAL STATEMENT, *supra* note 73, at 39; Ingram, *supra* note 40, at 55-56.

104. Coverage: Investment managers and advisers, including managers and trustees of collective investment schemes and in-house pension fund managers. THE NEW FRAMEWORK, *supra* note 99, at 8; see ADDITIONAL STATEMENT, *supra* note 73, at 41; Ingram, *supra* note 40, at 64.

105. Coverage: Life companies and unit trust managers and trustees, for the management and selling of insurance-linked investments or units in a collective investment scheme by themselves and their tied sales forces. THE NEW FRAMEWORK, *supra*

Life and Unit Trust Intermediaries Regulatory Organization ("LUTIRO").<sup>106</sup> Ultimately the SIB would recognize FIMBRA, AFBID, TSA, IMRO and LAUTRO as SROs.

The SIB intended SROs to have scope rules;<sup>107</sup> the effect of these rules would be to limit the kind of activities members may engage in unless otherwise authorized.<sup>108</sup> Membership in an SRO will thus not necessarily permit a firm to engage in all types of investment business. In this regard, a number of firms would be forced to join more than one SRO or combine membership in an SRO with direct authorization by the SIB in order to do a full range of investment business.<sup>109</sup> In addition, the SROs would have no freedom in setting capital adequacy standards, and their conduct of business rules would have to be equivalent to the rules prescribed by the SIB.<sup>110</sup>

It thus seemed extreme to believe that the SIB would depend so strongly on the SROs to monitor their respective markets, or that the SIB would have to give in to their collective bargaining power.<sup>111</sup> Rather it was empirically clear that the organizations were similarly committed and were taking measures to secure compliance with the new requirements because of a recognition that the changes were inevitable. However, it was also true that some aspects of the legislation failed to engage their enthusiasm. This was not too surprising in view of the complexity of the rules being developed by the SIB which involved significant changes from their prior practices.<sup>112</sup> For example, in considering an SRO for recognition, the SIB intended to pay close attention to the SRO's likely ability and willingness to act promptly upon any lead given by the SIB in tightening requirements in a particular

note 99 at 8; see ADDITIONAL STATEMENT, *supra* note 73, at 41; Ingram, *supra* note 40, at 64.

106. Coverage: Insurance and unit trust intermediaries, so far as their business is limited to life assurance and unit trust products. THE NEW FRAMEWORK, *supra* note 99, at 8; see ADDITIONAL STATEMENT, *supra* note 73, at 40; Ingram, *supra* note 40, at 64.

107. For an indication of the expected scope, see *infra* notes 112-19 and accompanying text. For a more detailed discussion, see ADDITIONAL STATEMENT *supra* note 73, at 37-41.

108. THE NEW FRAMEWORK, *supra* note 99, § 1.10.

109. See *Finance Brief: British Investor's Bill of Rights*, THE ECONOMIST, Apr. 30, 1988, at 92.

110. The result is supposed to be the avoidance of a multiline financial services company arbitraging against the cost of the rule by packaging an investment as one kind of product instead of another. 47 WASH. FIN. REP. (BNA) 546 (1986).

111. Dannen, *Faces of the New City*, INSTITUTIONAL INVESTOR, June 1986, at 77 (int'l ed.).

112. Woodley, *Foreword to REGULATION AND THE FINANCIAL SERVICES BILL, A SURVEY OF SENIOR EXECUTIVES IN INTERNATIONAL INVESTMENT BUSINESS* (available from Deloitte Haskins & Sells of London).



area.<sup>113</sup>

### 3.5. Functional Self-Regulation

The statutory system of regulation that has been put in place makes room for self-regulation subject to certain conditions and within certain carefully defined limits.<sup>114</sup> The whole system is full of checks and balances to ensure that the SROs do not become cozy clubs and cartels.

The relationship between the City and the Government in the United Kingdom has traditionally been one of informal contacts, mutual trust and self-regulation in which self-regulation was seen as having a dual function: a channel to the Government as well as a control mechanism for the Government. The Bank of England, for example, supervised the City<sup>115</sup> and served as a channel for communicating the City's views to the Government at the same time.<sup>116</sup>

Central to this system of self-regulation was the mutual affinity existing between the regulators and the regulated. One of the explanations for the secondary banking crisis was that the newcomers did not abide by the "normal rules of banking" even though no statutory provision forced them to do so.<sup>117</sup> Although the Banking Act 1979 put in place a more formal regulatory system, the Bank of England still preferred to try to use informal channels where possible to enforce its wishes.

By virtue of Section 150 of the PFI Act, the members of the Stock Exchange were exempted from having to apply for a license to deal in securities. The entire regulation was thereby left to the Stock Exchange which regulated both primary issues and the behavior of its members. This self-regulation without any form of supervision<sup>118</sup> witnessed several financial scandals at the beginning of the 1980s, and the Government was forced to consider the idea that, "even if it were practicable,

113. THE NEW FRAMEWORK, *supra* note 99, § 2.17. This criterion can still be implied from the general tone of the additional statement but is no longer explicitly mentioned.

114. Berrill, *supra* note 59, at 15.

115. It relied on government by way of consensus to obtain the desired result.

116. The Bank of England had encouraged the establishment of both the Take-over Panel and the Council for the Securities Industry. Graham, *The Bank of England, the City and the Reform of the Stock Exchange: Continuing the Self-Regulatory Community?*, 36 N. IRELAND LEGAL Q. 122, 130-133 (1985).

117. See H. McRAE & F. CAIRNCROSS, *supra* note 12, at 237 ("[T]he fringe banks could exist because of a regulatory gap which grew up between the Bank and the DTI."); see also Graham, *supra* note 116, at 138; Gardener, *supra* note 8, at 7-8.

118. However, there is the theoretical possibility of the DTI withdrawing recog-

we do not regard it as acceptable that the regulation of financial institutions should be left entirely to the institutions themselves."<sup>119</sup>

The SIB rules introduced surveillance and compliance, no longer voluntary but compulsory, into the British financial services industry. In this respect, the new system clearly departs from the past; the City relied on regulation as being equal to simple compliance with the rules for too long. The events of 1981 made it clear that this reliance was misplaced. Even though the Stock Exchange hurried to set up an Inspectorate to ensure surveillance and compliance,<sup>120</sup> public opinion forced the Government to step in. Once Professor Gower's Final Report, the DTI White Paper and the Financial Services Bill had been published, the universal reaction within the City was that the Bill's statutory provisions and range of powers were tougher than expected. Nevertheless, much power has been left in the hands of the market itself. Most agreed, however, that it would not take much to turn the SIB into a Securities and Exchange Commission ("SEC") type institution, especially in the wake of the Guinness insider trading scandal.<sup>121</sup>

The simultaneous deregulation of the City in terms of removing all existing barriers between segments of the financial services industry<sup>122</sup> and re-regulation of private investor protection through a statutory framework,<sup>123</sup> which provided for functionally based SROs, necessarily led to the problem of firms being confronted with more than one regulator. The new framework is characterized by multipurpose firms subject to regulation by supervisors organized along functional lines. This proliferation of supervision could lead to duplication of reporting efforts and increased costs. There is the potential for confusion about the various supervisors and a considerable area for conflict between their requirements. This could encourage financial groups to structure themselves according to the perceived laxity or stringency of different supervisors rather than the financial and managerial requirements of any group's operations.<sup>124</sup> The problems of functional regulation hereby created will be further discussed in the next part.

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119. WILSON COMMITTEE REPORT ON THE FUNCTIONING OF FINANCIAL INSTITUTIONS, 1980 (Cmd. 7937) at 1108.

120. Wilkinson, *supra* note 34, §§ 7.1-7.2.

121. Marshall, *Guinness Affair Rocks Britain's Financial Club*, L.A. Times, Feb. 2, 1987, pt. iv, at 1; *Rules for the City*, THE ECONOMIST, Feb. 7, 1987, at 17.

122. This includes the removal of Stock Exchange Rules blocking entrance of banks in the business of issuing securities in the United Kingdom and the removal of the restrictions on activities of building societies.

123. Financial Services Act, 1986, ch. 60.

124. Galpin, *supra* note 82, § 4.2. The ISRO, for example, made it clear that there was a strong desire for regulatory economy among its members. Agnew, *supra* note 68, § 6.1.

#### 4. FINANCIAL REGULATION ALONG FUNCTIONAL LINES UNDER THE NEW REGULATORY FRAMEWORK

##### 4.1. *Overlaps within the Regulatory Framework for Investment Business*

One way a single firm could avoid problems of multiple authorization and regulation is to obtain direct authorization from the SIB. This alternative is viable since the SIB has a complete rule book to regulate the activities of the firm while the firm is active on the exchanges.<sup>125</sup> Although Professor Gower seemed to suggest direct authorization as an alternative only in cases where a certain market segment was without an SRO when the new framework came into force, it is clear from the DTI White Paper and subsequent statements by Government officials that direct authorization is a complete alternative to multiple membership in SROs.<sup>126</sup> The SIB, however, does not want to be involved with much day-to-day regulation and has not encouraged firms to apply for direct authorization, but it expects that some foreign firms will do so.<sup>127</sup>

Authorization through membership in SROs, on the other hand, may have the inherent danger of encouraging SRO-shopping. It seems unlikely that this will be possible given the fact that the capital requirements of the SROs will have to be identical and not just equivalent<sup>128</sup> to those of the SIB. In addition, the SIB only intends to recognize one SRO per market segment thereby eliminating competition among SROs for membership. As a result, a firm will only have a choice between membership in the SRO competent for the particular market segment<sup>129</sup> or direct authorization by the SIB.

The key to the soundness of the whole system seems to lie with the SIB and the way in which it will use the recognition powers it has under the Financial Services Act. The SIB's Regulation of Investment Business Rules do not contain any explicit indication as to how these powers will be used. An indication can be found, however, in the additional statement submitted to the Secretary of State as a supplement to

125. The Financial Services Act distinguishes from recognized investment exchanges. Financial Services Act, 1986, ch. 60, §§ 8(1), 36(1).

126. Howard, *Keynote Address*, in *THE CITY AFTER THE FINANCIAL SERVICES ACT: A FINANCIAL TIMES CONFERENCE* § 2.2 (1986).

127. ADDITIONAL STATEMENT, *supra* note 73, at 8. Nevertheless some 108 firms seem to have taken this course of action. Morrissey, *FSA Getting Your Act Together by A-day*, 9 INT'L FIN. L. REV., May 1988, at 7.

128. Berrill, *Keynote Address*, in *THE CITY AFTER THE FINANCIAL SERVICES ACT: A FINANCIAL TIMES CONFERENCE* § 3.2 (1986).

129. However, the firm possibly may choose an SRO competent for another market segment, but this will depend on the boundaries of the scope rules that the SIB

these draft rules and regulations when they were published at the beginning of February 1987. The SIB proposed to enter into a Memorandum of Understanding on mutual cooperation and exchange of information with the SROs and other bodies it recognizes.<sup>130</sup> In the process of recognizing SROs, the SIB intended to have detailed discussions with prospective SROs on the question of sharing information with the SIB and other supervisory authorities, and an SRO would be required to confirm its willingness to cooperate with the SIB and other relevant regulators in order to obtain recognition.<sup>131</sup>

In its pamphlet entitled "Regulation of Investment Business: The New Framework," the SIB suggested the concept of a lead-regulator as a possible solution for the overlaps of regulatory powers within the system of the Financial Services Act as such.<sup>132</sup> In addition, the SIB pro-

130. ADDITIONAL STATEMENT, *supra* note 73, at 25.

131. *Id.* at 39.

132. The SIB explained:

The lead regulator will generally be the SRO responsible for the largest part of a firm's business. Other SROs will be able to provide for financial monitoring of the firm to be done by the SRO which is the lead regulator: for each multiple-authorized firm there will need to be a clear understanding as to which SRO this will be, and the Board will wish to be informed of all such arrangements. Where the firm is authorized by the Board for any significant amount of business, the Board will normally itself assume the role of lead regulator. Close cooperation between SROs will be an essential part of the system and an SRO's willingness to share information with others will be a requirement of recognition.

*The lead regulator will receive and assess all information relevant to the capital adequacy of the firm and set requirements for the firm as a whole.* It will notify other SROs in the event of any problem and will coordinate remedial action should this be necessary. Other SROs will be expected to use their powers, in cooperation with the lead regulator, to limit a firm's business, in the event of its becoming over-extended.

*The lead regulator would have no role in setting or monitoring compliance with conduct of business rules* in areas that are not within the scope for which it has authorized the firm. But disciplinary cases started by any SRO should be notified to the lead regulator as they may affect confidence in a financial sense and may in some cases cast doubt on competence and probity generally. Nothing in the lead regulator approach is intended to lessen the ability of any SRO to form an independent judgment as to the 'fitness and properness' of the firm outside the area of capital adequacy.

It is possible that the lead regulator concept could usefully be adapted to groups of companies which may be individually authorized by different SROs and subject to their individual capital and monitoring requirements. The Board will wish to ensure that capital, assessed on a group basis, takes full account of the relationships between individual members of the group and their own individual positions, and will seek to ensure that the monitoring of capital is done by a single lead regulator in cooperation with all of the interested SROs. Again, if the Board were involved in any significant part of the group it would normally expect to perform this function. The group lead regulator would coordinate the exercise of powers by

posed two types of arrangements between regulators:

(1) *Arrangements for the consultation and sharing of information between regulators with a regulatory interest in the same group or firm.* These will be put in place in order to ensure an adequate and effective liaison between regulators in monitoring a supervised group or firm and will relate principally to matters of financial supervision. However, information concerning business conduct and other matters will also be shared where appropriate. The goal is to ensure that all of the regulators oversee the group, while as an individual regulator each is responsible only for the day-to-day supervision of part of the group.<sup>133</sup> The designated lead-regulator will call meetings for the sharing of information on a regular basis (probably annually) as well as on an ad hoc basis.<sup>134</sup>

(2) *Arrangements for the delegation of financial monitoring by an SRO or SIB.* The Act permits an SRO or the SIB to make arrangements whereby the task of day-to-day monitoring can be delegated by one regulator to another. Such delegation can happen whenever the recognizing body is satisfied that the arrangements made by the monitoring body are adequate.<sup>135</sup>

These arrangements are designed to avoid imposing unnecessary duplication or conflict of financial reporting requirements upon the supervised firm and to avoid the overlap of supervisory efforts by regulators. The SIB intends to encourage these arrangements but recognizes that they remain voluntary since they are entirely at the option and judgment of the individual regulators.<sup>136</sup>

## 4.2. Overlaps Among Regulators of Different Functions

### 4.2.1. Listed Money Market Institutions

The SIB will have to share its regulatory powers with the Bank of England in at least two segments of the investment business market. Listed money market institutions are exempt from the need to obtain authorization under the Financial Services Act. To ensure that there

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the individual SROs with respect to companies within the group and the capital dedicated to the various firms' activities.

THE NEW FRAMEWORK, *supra* note 99, §§ 1.19-1.22 (emphasis added).

133. ADDITIONAL STATEMENT, *supra* note 73, at 25.

134. *Id.* at 26.

135. Financial Services Act, 1986, ch. 60, sched. 2, § 4(2) (dealing with SROs); *id.*, sched. 3, § 4(4) (dealing with recognition of professional bodies); *id.*, sched. 4, § 3(2) (dealing with recognition of investment exchanges); *id.*, sched. 7, § 3(2) (dealing with the SIB) (Schedule 7 expressly provides that *only* monitoring and not enforcement can be delegated, but the same conclusion can be implied from the other schedules).

136. ADDITIONAL STATEMENT, *supra* note 73, at 26.

are no material gaps in the regulatory framework which might weaken the degree of protection afforded to investors, exemption from the ambit of the Financial Services Act will be granted only if institutions carry out the transactions appearing on a list created by the Bank of England. Work was progressing at the end of 1986 on a consultative document setting out detailed proposals for the Bank regulation of these markets and the qualifying conditions for appearing on the list.<sup>137</sup> These proposals include "conduct of business rules",<sup>138</sup> "fit and proper criteria,"<sup>139</sup> and requirements for capital adequacy.

The wholesale market in sterling, foreign exchange and bullion, which the Bank will supervise under the new arrangements, are defined in terms of instruments traded, the institutions trading and the size of the transactions usually involved.<sup>140</sup> With regard to capital adequacy criteria, the Bank proposed to make two sorts of distinctions: (1) an institutional distinction in which each would apply its own independent test as wholesale-market supervisor to some listed institutions but not to others already supervised by certain other regulatory authorities; and (2) a functional distinction between firms acting as principal clearers and those acting purely as brokers.<sup>141</sup> Where the Bank itself set the capital test under the Banking Act 1979, it would take those into account and apply no other tests. However, where the tests are set by another supervisor,<sup>142</sup> the Bank announced it would discuss with that other supervisor how best to reduce unnecessary supervisory overlap. The Bank would investigate on a case-by-case basis whether the monitoring of capital adequacy should be delegated to the other supervisory authority with the Bank retaining the authority to assure adequate capitalization of the listed institutions. In the cases where the Bank would not be directly assessing capital adequacy itself, it would seek to ensure that the standards applied were commensurate with those which it applied in wholesale-market trading.<sup>143</sup>

The problem of clearly dividing the responsibilities between the

137. The Bank of England published a draft framework in December 1986. *BANK OF ENGLAND, THE FUTURE REGULATION OF THE WHOLESALE MARKETS IN STERLING, FOREIGN EXCHANGE AND BULLION* (1986) [hereinafter *THE FUTURE REGULATION*]; see Ingram, *supra* note 40, at 63.

138. For example, the institutions would have to agree to observe the Code of Conduct of Wholesale Markets that was in force under the Bank of England's prior prudential regulatory authority. The intention is not to change the fundamental principles involved but to ensure that they are universally known and observed.

139. *THE FUTURE REGULATION*, *supra* note 137, at 4.

140. *Id.* at 2.

141. *Id.* at 5.

142. For example, the document refers to the Building Societies Commission in the case of building societies. *Id.*

143. *Id.* at 6.

Bank and other supervisors of wholesale instruments remains. The Bank's responsibilities in this area should help eliminate the overlaps which would have occurred had regulation of the wholesale markets fallen exclusively to the Financial Services Supervisors.<sup>144</sup>

#### 4.2.2. *The Gilt-Edged Market*

The Bank of England has also retained its power over the gilt-edged market.<sup>145</sup> In order to ensure that the entire gilt-edged market is subject to Stock Exchange regulations as far as trading practices and professional standards are concerned, the market makers, Stock Exchange money brokers,<sup>146</sup> and inter-broker-dealers<sup>147</sup> will be required to be members of the Stock Exchange. The Bank requires the market makers to have dedicated sterling assets in the United Kingdom and maintains close supervision of the adequacy of their capital in relation to the exposure to various risks. In addition, the Bank monitors the performance of the market makers functional obligations.<sup>148</sup> To supplement this prudential supervision, the Bank has required all gilt-edged market making entities to be members of the Stock Exchange. As a result, the Stock Exchange Compensation Fund will be available to

144. Galpin, *supra* note 82, § 4.4.

145. However, the gilt-edged market is not exempt from regulation under the Financial Services Act. See Financial Services Act, 1986, ch. 60, sched. 1, §§ 3, 4 (dealing with government securities). With regard to the restructuring of the gilt-edged market, the Bank of England's original proposals were published in November 1984 and reprinted in 24 BANK ENG. Q. BULL. 513 (1984). An updated version was published in April 1985. BANK OF ENGLAND, THE FUTURE STRUCTURE OF THE GILT EDGED MARKET: THE BANK OF ENGLAND'S DEALING RELATIONSHIP WITH CERTAIN PARTICIPANTS (1985), reprinted in *The Future Structure of the Gilt Edged Market*, 25 BANK ENG. Q. BULL. 250 (1985) [hereinafter *The Future Structure of the Gilt Edged Market*]; see I. KERR, *supra* note 38, at 92.

146. "The main function of [Stock Exchange] money brokers [is] to act as intermediaries in stock borrowing and lending, to lend funds to market makers running net long positions in stock and to take funds from market makers running net short positions in stock." *The Future Structure of the Gilt Edged Market*, *supra* note 145, at 274.

147.

[Inter-broker dealers will] operate between market makers, taking bids and offers for stock from market makers and disseminating them among the other market makers, [thereby making it] easier for market makers to unwind stock positions that arise from their market making activities with investors or their agents. . . [Inter-broker dealers] will consequently contribute to the overall liquidity of the market.

*Id.* at 280.

148. In return for their dealing relationship with the Bank of England, the market making firms have undertaken "an obligation to make, on demand and in any trading conditions, continuous and effective two-way prices." Jackson, *supra* note 14, at 547; see *The Future Structure of the Gilt Edged Market: Official Operations*, 26 BANK ENG. Q. BULL. 569 (1986).

compensate the outside customers of member firms and subject the entities to Stock Exchange regulation with regard to questions of fairness, conflict of interest and professional competence.<sup>149</sup>

#### 4.2.3. *The Insurance Industry*

Under the Financial Services Act, the SIB's Conduct of Business Rules will apply to insurance companies and friendly societies only with respect to "marketing" policies and the management and marketing of pension funds. The financial resources rules will not apply since the remaining areas will be covered by the other regulatory systems.<sup>150</sup>

#### 4.2.4. *Regulatory Responses to These Overlaps*

With regard to the blurring of distinctions between functions in the financial services industry, the SIB's *Regulation of Investment Business: The New Framework* stated:

The Board is considering together with other financial regulators, the extent to which the lead regulator concept may have application outside the system of investment business authorization. In particular it will be concerned to minimize duplication in reporting requirements on banks which are authorized as deposit-takers by the Bank of England but may also require authorization in respect of their investment business by the Board or by an SRO. More generally there will be a need for close coordination between all regulatory authorities with regard to conglomerates with interests in a range of financial activities. The Board will expect to use its powers to share information within a network of financial regulators both in this country and overseas.<sup>151</sup>

The Governor of the Bank of England has made it clear that although none of the supervisors could give up responsibility over his own area, they must all give regard to the activities going on elsewhere in the same firm or group of firms. He supported the idea of agreeing on procedures permitting cooperation and the exchange of information between various supervisors while the Bill was still pending.<sup>152</sup>

Relations have been established between the main supervisors and regulators to work out this concept of sharing supervisory responsibil-

149. George, *supra* note 2, at 425.

150. EXPLANATORY STATEMENT, *supra* note 83, § 8.

151. THE NEW FRAMEWORK, *supra* note 99, § 1.23.

152. Governor of the Bank of England, *supra* note 20, at 72.



ity. From the point of view of the Bank of England, the financial services regulators (i.e., the SIB and SROs) will probably take the lead in developing standards for the conduct of business, while the Bank will assume the monitoring role for banks subject to multiple authorization. Both would agree on a common set of prudential standards especially for capital cover and facilitating the delegation of monitoring. The Bank also intends to discuss the coverage, the procedures and the form of liaison between the supervisors with the supervisors and the institution involved whenever the monitoring has been delegated to the Bank.

The Bank further indicated that a distinction will be made between supervision over a single institution subject to multiple authorization and the regulation of a financial conglomerate. In the case of a financial conglomerate, the lead regulator will act as the chairman of a college of all the supervisors with an interest in the group, and his role will be to promote the exchange of information between supervisors and to ensure that there is a proper coordination of their activities. Responsibility for taking action will remain with each supervisor within his own area of statutory responsibility.<sup>153</sup>

The Financial Services Act has greatly promoted this exchange of information by enabling financial services supervisors to disclose information to other supervisors and by removing the constraints on the disclosure of information to other supervisors in the Banking, Companies and Insurance Companies Acts.<sup>154</sup>

During 1987, talks continued between the SIB and the Bank of England in an effort to reach an agreement on the application of the lead regulator concept to banks. An agreement seems to have been reached whereby the Bank will monitor financial resources and overall soundness if a bank keeps its securities business on its own balance sheet. If, on the other hand, it uses a separate subsidiary for that business, the SIB or an SRO will do the monitoring of the subsidiary and its business, while the Bank will continue to monitor the bank qua bank.<sup>155</sup>

As lead regulator, the Bank would

send a quarterly report to the SIB or the SRO certifying that the bank is complying with the required capital ratios and

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153. Galpin, *supra* note 82, § 4.3.

154. While the disclosure of information is restricted, there is an exception "for the purpose of enabling or assisting a recognized self-regulating organisation, recognised investment exchange, recognised professional body, or recognised clearing house to discharge its functions as such." Financial Services Act, 1986, ch. 60, §§ 179-80.

155. *The City of Europe in Learning to Manage - A Survey of the City of London*, THE ECONOMIST, June 25, 1988, at 31.  
Published by Penn Law: Legal Scholarship Repository, 2014

giving details of its activities in the securities markets. If a problem arises, even in the securities side, the Bank will deal with it, and the SIB can intervene only at the Bank's invitation.<sup>156</sup>

Unfortunately, no official text of such an agreement has been published. The SIB and the Bank of England have continued discussing the related problems and seem to distinguish between three types of overlaps: (1) the bank has acquired securities; (2) the bank engages in securities trading on a full-fledged basis; and (3) the bank engages in securities trading on a *de minimis* basis. Both parties hope to finalize their agreement in the near future, and the agreement will probably become public when officially communicated by the Bank of England to the British Banker's Association. In regard to the institutions that are exempt from regulation under the Financial Services Act, Memoranda of Understanding probably have been entered into with the different institutions.

## 5. CONCLUSION: A MODEL FOR FUTURE U.S. RE-REGULATION?

It would be wrong to describe the changes that took place in the United Kingdom as deregulation; rather, this is a perfect example of re-regulation. Although initiated primarily in reaction to the problems caused by a failing system of investor protection, the emerging regulatory structure has tried to take into account the market realities: financial conglomerates active in different market segments. The statutory backed self-regulatory system is organized along functional lines, and everything has been done to encourage the regulators to coordinate and cooperate in the exercise of their functions and powers. Both conclusions are important for the current debate in the United States.

From the 1930s and into the 1970s, Congress established a regulatory system for the U.S. financial services industry based along industry lines: "[b]anks were regulated by banking agencies, broker-dealers by state and federal securities agencies, and federal savings and loan associations and federal savings banks by thrift agencies."<sup>157</sup> The legislative history suggests that Congress wanted to have a market "in which banks, broker-dealers, thrifts and insurance companies would not compete outside their industry."<sup>158</sup> Since the 1930s, however, firms from

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156. *Financial Regulation: SIB and Bank Agree on Supervision of Banks Under FSA*, 2 J. INT'L BANKING L. N-110 (1987)

157. Peters & Powers, *supra* note 5, at 1077; see Friedman & Friesen, *supra* note 2, at 416-27.

158. Peters & Powers, *supra* note 5, at 1080.

different industries within the financial world have competed increasingly across industry border lines, a phenomenon which has accelerated in the last ten years. This cross-industry competition threatens the integrity of the institutionally based regulatory structure.

Although several proposals were made in response to this problem,<sup>159</sup> most of these proposals attempted to find a new congruence between financial institutions and existing regulators. The Reagan Administration proposal only included the suggestions of the Bush Task Force Report,<sup>160</sup> which were limited to a streamlining of the regulatory powers of federal banking regulators, and it did not address the related issue of whether financial institutions should be allowed to enter the other segments of the financial services industry.<sup>161</sup>

The debate on how to re-regulate the U.S. financial markets intensified when the President of the Federal Reserve Bank of New York, E. Gerald Corrigan, gave a speech before the New York State Banker's Association. Corrigan argued in favor of eliminating many of the distinctions between banks, securities firms and insurance companies, while at the same time explicitly addressing some of the issues this would raise at the regulatory level.<sup>162</sup>

Rather than favoring a wholesale deregulation including the systematic relaxation or elimination of the separation of banking and commerce, Corrigan argued for moving in the direction of a more uniform and integrated approach to the operation and supervision of the banking and financial system, while still preserving the distinction between "banking" and the remainder of the economy. According to Corrigan, "the blending of banking and commerce raise[d], a host of potential problems ranging from its consequences for the impartiality of the credit decision making process to the operation and reach of the supervisory system and the public safety net more generally."<sup>163</sup> As an alternative, however, Corrigan was willing to accept the blurring between classes of financial institutions and financial functions while seeking to preserve the distinction between banking-finance and commerce.<sup>164</sup> As a result of the proposed framework, the existing legal barriers prevent-

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159. For a discussion of these proposals, see Friedman & Friesen, *supra* note 2, at 442-45.

160. See *supra* note 6 and accompanying text.

161. *Functional Regulation, Other Provisions in Administration's Competitiveness Bill*, *supra* note 5, at 343.

162. See Quint, *Sweeping Changes in Financial System Urged*, N.Y. Times, Jan. 30, 1987, at 1, col. 4; Kutler, *NY Fed Chief Proposes Major Overhaul in Structure of Financial Services Industry*, Am. Banker, Jan. 30, 1987, at 1, col. 2.

163. Corrigan, *Financial Market Structure: A Longer View* 25 (1987) (essay by the President of the Federal Reserve Bank of New York).

164. *Id.* at 26.

ing various classes of financial institutions from engaging in certain types of financial activities would be largely eliminated, and the structure would be similar to the post-Big Bang environment in the United Kingdom.<sup>165</sup>

At the regulatory level, the various supervisory and regulatory requirements would have to be met. Firms that would gain access to the payment system and to the discount window would become subject to a degree of consolidated supervision by the Federal Reserve and would be subject to interest earning liquidity reserves. However, consideration of the important changes that would have to take place in the supervisory apparatus remained limited to a discussion of certain interim changes. According to Corrigan, it would not be necessary or desirable to immediately restructure the entire federal and state regulatory apparatus in light of the fact that the market system itself had to go through a period of transition and evolution. Rather, experience should first be gained with the financial structure as it would develop.<sup>166</sup>

Although Corrigan proposed the establishment of a "Financial Services Oversight Board" in order to insure that his definition of "financial services" would be uniformly applied to maintain a meaningful distinction between "banking-finance" and "commerce," he did not further address the issue of cooperation between the federal and state regulators. This issue necessarily follows from his acceptance of affiliations among banks, thrift companies, insurance companies, securities companies and other wholly financial firms in conjunction with the maintenance of the existing regulatory structure which exercises its regulatory tasks on a functional basis.

Other proposals have similarly addressed the issue of redesigning financial regulation in the United States. These proposals focus especially on what an enterprise with a bank in its corporate structure could do elsewhere in the financial services industry via non-bank affiliates or subsidiaries and on how such an enterprise should be regulated. Like the Corrigan proposal, they opt for a system of functional regulation exercised through the existing regulators. The debate is concerned with whether the entity owning a bank should be subject to consolidated official supervision and whether banks should be permitted to affiliate themselves with non-financial as well as financial enterprises.<sup>167</sup>

A process of changing the existing institutionally based regulatory

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165. *Id.* at 42.

166. *Id.* at 43.

167. Huertas, *supra* note 1, at 16-17; for a critical discussion of the assumptions underlying these proposals for regulatory reform, see Parry, *supra* note 3.

system into a system of functional regulation should provide for the necessary means of cooperation among the various regulators. The issue of cooperation does not seem to have been addressed by the proposals for regulatory reform yet. The United Kingdom's Financial Services Act can be used as an example in this regard: provisions have been inserted allowing the exchange of information and delegation of certain monitoring tasks among the regulators. Contrary to the U.S. experience, however, the British financial services industry has traditionally been characterized by a process of informal contacts between regulators and between the regulators and the regulated firms. In turn, these contacts facilitated the needed cooperation. It is an open question whether this willingness to cooperate - the basis for the success of a re-regulation along the U.K. model - is present in the U.S. financial services industry.