HOUSE OF COMMONS SESSION 1994-95

TREASURY AND CIVIL SERVICE COMMITTEE

Sixth Report

THE REGULATION OF FINANCIAL SERVICES IN THE U.K.

VOLUME I

Report, together with the
Proceedings of the Committee

Ordered by The House of Commons *to be printed*
23 October 1995

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The Treasury and Civil Service Committee is appointed under Standing Order No 130 to examine the expenditure, administration and policy of the Treasury and the Office of Public Service and Science (but excluding the Office of Science and Technology and the drafting of bills by the Parliamentary Counsel Office), the Board of Customs and Excise and the Board of the Inland Revenue.

The Committee consists of a maximum of 11 members, of whom the quorum is three. Unless the House otherwise orders, all members nominated to the Committee continue to be members of it for the remainder of the Parliament.

The Committee has power:

(a) to send for persons, papers and records, to sit notwithstanding any adjournment of the House, to adjourn from place to place, and to report from time to time;

(b) to appoint specialist advisers either to supply information which is not readily available or to elucidate matters of complexity within the Committee's order of reference;

(c) to communicate to any other committee appointed under the same Standing Order (or to the Committee of Public Accounts or the Deregulation Committee) its evidence and any other documents relating to matters of common interest;

(d) to meet concurrently with any other such committee for the purposes of deliberating, taking evidence, or considering draft reports.

The Committee has power to appoint one sub-committee and to report from time to time the minutes of evidence taken before it. The sub-committee has power to send for persons, papers and records, to sit notwithstanding any adjournment of the House, and to adjourn from place to place. It has a quorum of three.

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13 July 1992

The following were nominated as members of the Treasury and Civil Service Committee:

Ms Diane Abbott
Sir Thomas Arnold
Mr A J Beith
Mr Nicholas Budgen
Mrs Judith Chaplin (decd 19.2.93)
Mr Quentin Davies
Mr John Garrett
Mr Barry Legg
Mr Giles Radice
Mr Brian Sedgemore
Mr John Watts

Mr John Watts was elected Chairman on 15 July 1992.

Sir Thomas Arnold was elected Chairman in the place of Mr John Watts on 19 October 1994.

The following changes in the membership of the Committee have been made.

Monday 29 March 1993:	Mr Nigel Forman appointed.
Monday 13 December 1993:	Mr John Garrett discharged. Mr Mike O'Brien appointed.
Monday 31 October 1994:	Mr John Watts discharged. Mr Matthew Carrington appointed.
Wednesday 28 November 1994:	Mr A J Beith discharged. Mr Malcolm Bruce appointed.

The cost of preparing for publication the Shorthand Minutes of Evidence published with this Report was £16,263.74
The cost of printing and publishing these Minutes of Evidence is estimated by HMSO at £1,648.00.

THE REGULATION OF FINANCIAL SERVICES IN THE U.K.

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SIXTH REPORT

The Treasury and Civil Service Committee has agreed to the following Report:

THE REGULATION OF FINANCIAL SERVICES IN THE U.K.

I. INTRODUCTION

Background

1. This is the fourth and final Report resulting from the Treasury and Civil Service Committee's long-running inquiry into financial services regulation in the United Kingdom, which began in January 1994. Earlier Reports - on retail financial services[1], on the building societies[2], and on Lloyd's of London[3] - have dealt in some detail with the principles governing the regulation and supervision of particular sectors of the financial services industry, and the regulatory structure in those sectors.

2. Issues concerning supervision and regulation in financial sectors not directly covered by the Financial Services Act - notably the banking industry - have also been separately addressed by the Committee during the lifetime of this Parliament. In particular, the Committee has reported on the implications of Sir Thomas Bingham's inquiry into the closure of the Bank of Credit and Commerce International,[4] and on the role of the Bank of England both as supervisor and monetary authority[5]. It has recently also begun to take evidence on the collapse of Barings Bank, both in the closing stages of the current inquiry into financial services regulation, and in separate evidence from the Bank of England.[6] We expect to return to the subject of the collapse of Barings Bank in a separate Report.

3. The present Report seeks to draw together the various themes considered in the earlier Reports referred to above, and in the very substantial body of evidence taken on all aspects of supervision and regulation during the last two years. The Report does not seek to be all-embracing either in its analysis or in its conclusions. It would be not only a herculean task to attempt to utter the last authoritative words on every aspect of this vast subject; it would also be naive to assume that there are final and unchallengeable conclusions to be reached at any one time about the supervision and regulation of an industry in a state of constant evolution and change. What can be done, however, is to assess the development of the regulatory system during the decade since the passing of the Financial Services Act in 1986, and to consider whether the principles which underlay that legislation still hold good, whether those principles are being effectively applied, whether a radically different approach is required, and whether, even if the principles remain valid, radically different institutional solutions are necessary or desirable.

4. This Report is therefore "final" only in the sense that it brings this phase of the Committee's inquiries to a conclusion, and will provide a reference point for the Committee's future examination of issues arising in the field of financial services regulation and supervision. The transfer of ministerial responsibility for most aspects of the new regulatory regime from the Department of Trade and Industry to HM Treasury at the beginning of this

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[1] Fourth Report, Session 1993-94 (HC 236): *Retail Financial Services: An Interim Report*

[2] Second Report, Session 1994-95 (HC 26): *Financial Services Regulation: The Building Society Sector.*

[3] Fifth Report, Session 1994-95 (HC 187-I): *Financial Services Regulation: Self-Regulation at Lloyd's of London.*

[4] Second Report, Session 1992-93 (HC 250): *Banking Supervision and BCCI: The Implications of the Bingham Report*

[5] First Report, Session 1993-94 (HC 98-I): *The Role of the Bank of England*

[6] Minutes of Evidence, Session 1994-95, (HC 746-i): *Board of Banking Supervision: The Report on the Collapse of Barings Bank.*

Parliament[7] created major new functions for the Treasury Department, and in consequence created major new responsibilities for the Treasury & Civil Service Committee. As a result, much of our time since our reappointment has been devoted to these issues, and we anticipate that much of our time in the future will be similarly occupied.

5. The existence of this general inquiry into financial services regulation has provided an opportunity for almost all sectors of the industry to explain their concerns and their expectations of the regulatory regime, and has stimulated wide debate in the industry and the media. We hope that our conclusions in this Report, if generally accepted within the industry as valid, will enable all the parties concerned - Government (and Parliament), the regulators, and the industries themselves - to work together towards a regulatory structure which will create the level of public confidence required to enable the United Kingdom financial industries to compete successfully in European and world markets into the next century.

6. For the issues addressed in this Report concern not merely the protection of investments and the interests of the individual private investor - vitally important though such protection must be. They also concern the long-term health of the United Kingdom's major export industry. Failures in the regulation and supervision of that industry do not simply have financial consequences for the individuals concerned: they can also threaten the balance of payments, the stability of the currency and the prosperity of the national economy as a whole, to the extent that they threaten confidence in that industry, either at home or overseas.

7. Recent failures in the banking industry - such as Johnson Matthey (in 1984), BCCI (in 1991) and Barings Bank (in 1995) - and the continuing crisis of recent years in the Lloyd's insurance market, have demonstrated areas of continuing weakness in the supervision and regulation of sectors not covered by the Financial Services Act, and have done little to enhance the domestic or foreign confidence to which we have referred. Accordingly, although this inquiry has concentrated in particular on the adequacy of the Financial Services Act, our conclusions cover a rather wider area, and the underlying principles which we espouse are equally relevant to the areas excluded from the 1986 Act as they are to those covered by the Act.

8. Our Report contains a number of proposals for changes in the regulatory and supervisory system: some are proposals made in our earlier Reports but not yet acted upon; some reflect the frustrations of the regulatory bodies themselves in trying to implement the intentions of the Financial Services Act and other legislation; and some have become apparent as the evidence from all parts of the industry has accumulated during this lengthy inquiry. Ten years ago much of the activity covered by the present regulatory system was largely free of regulation or control, other than that provided by the Companies Acts and the normal civil and criminal law: we are therefore conscious of the need to resist the temptation to espouse major structural changes which might set back, rather than encourage, the remarkable progress which has been made in the past decade.

Conduct of the inquiry

9. The Committee took evidence in January 1993 from the then Economic Secretary to the Treasury, Mr Anthony Nelson MP, on the transfer of ministerial responsibility for financial services from the Department of Trade and Industry to the Treasury.[8] Subsequently, in June 1993,[9] evidence was taken from Mr Andrew Large, the Chairman of the Securities and Investments Board, following the publication of his influential Report on the operation of the 1986 Financial Services Act.[10]

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[7] Transfer of Functions (Financial Services) Order 1992 (SI, 1992, No.1315).

[8] Minutes of Evidence, 20 January 1993 (HC 410-i).

[9] Minutes of Evidence, 14 June 1993 (HC 733-i).

[10] *Financial Services Regulation: Making the Two Tier System Work (SIB, May 1993).*

10. Following the announcement of our full inquiry we took oral evidence on forty-six separate occasions between February 1994 and July 1995. Almost all this evidence has been published in separate daily parts, and some has also been published in volumes of evidence attached to the three interim Reports - on Retail Financial Services, the Building Society Sector, and Lloyd's of London - referred to above.[11] Much of the remainder is published with this Report (as Volume II).

11. A very substantial amount of written evidence has also been received. Many of these papers have been published in appropriate volumes during the course of the inquiry, and further papers are published in volume III of this Report. Some were of an ephemeral nature, or have been overtaken by later developments, and have therefore not been published.

12. The Committee are very grateful to all those who have given evidence, either in person or in writing, during the course of the inquiry, as we are to our Advisers and Assistants.

[11] Para.1.

II. THE FINANCIAL SERVICES ACT IN PRACTICE

After the Large Report

13. Following a request from the then Chancellor of the Exchequer, Mr Andrew Large (the recently appointed Chairman of the Securities and Investment Board [SIB]) published a wide ranging report into the regulation of financial services in May 1993.[12] The request for this review of the operation of the Financial Services Act was brought about in part because of the need to improve the performance of IMRO and SIB following the Maxwell affair, but also because the system was being buffeted by persistent criticisms from the industry, investors and consumers. As Mr Andrew Large himself conceded when he gave evidence to this Committee following publication of the Report "I think that it is inevitable, after a period of years in getting the system up and operating, that weaknesses may begin to appear."[13]

14. The Large Report set out (in paragraph 22) the considerable efforts that were still needed by the regulators to make the system work effectively. In the above quoted evidence session Mr Large said that "I would be very disappointed if within two years we do not see a significant change, both in how we regulate and, just as importantly, in how we are perceived to be regulating." [14] It is timely therefore to consider the particular changes that Mr Large tried to make in the operation of the regulatory and supervisory system and to consider how far developments since his Report have contributed to a growth in public confidence.

15. After two years of immersion in the subject we are well aware of the difficulties involved in interpreting and articulating the details of the Act. The task of protecting investors without stifling the industry is demanding and multi-faceted. Financial services is a fast changing, dynamic and innovative market place where products and attendant risk structures are increasingly tailored to meet individual needs and where the main players are not constrained in their activities by institutional or geographical boundaries. Clearly it is not for this Committee to consider in minute detail the day-to-day operations of the financial regulatory community, nor their every policy responses to situations that have arisen. What this Committee can and should do, however, is to consider whether the original guiding principles which shaped the legislation are still clearly reflected in regulatory practices, whether the key objectives are being delivered, and whether the vision which the regulatory community offers as to how the system will evolve is a sufficiently sound one. It is also the Committee's responsibility to report to Parliament if we believe that the time has come when legislators need to amend (by strengthening, or removing obstacles or clarifying grey areas) the original framework within which the regulatory community operates to enable them to deliver their objectives more effectively.

16. In the summary section of his Report Mr Large highlighted a number of criticisms made to him during his review. They are worth listing again so that an assessment can be made of whether those criticisms have been met, whether they are still current or whether they have been superseded by other concerns:

"i. the objectives of the Act are unclear;
ii. there is a suspicion that self-regulation equates with self-interest;
iii. cost effectiveness is not evident;
iv. too much fraud goes unpunished;
v. the system is too complex;
vi. the retail area is ineffectively regulated;
vii. the regulation of professionals is still not sufficiently distinguished from that of the retail market;

[12] *Financial Services Regulation: Making the Two Tier System Work*, (SIB, May 1993).

[13] HC(1992-93) 733-i, Q3.

[14] Q67.

viii. the compensation scheme is unfair as to funding and inappropriately structured;
ix. the regulation of exchanges and markets is imprecisely defined."[15]

17. Many of these criticisms, in particular ii-v, were again made to us in our most recent round of evidence sessions, and we will consider a number of them in the paragraphs that follow. Mr Large's response to these original criticisms was to set out in a detailed plan of action which attempted "changes in attitudes and approach of all in the regulatory world". There have, it is clear to the Committee, been a number of changes in attitude and approach since the Large report, not all of which have necessarily been in the vein Mr Large would have wanted. Nevertheless many of the original criticisms made to Mr Large persist, and we believe that they cannot necessarily all be overcome by attempts further to reinterpret the Financial Services Act in its present form.

18. This chapter focuses on a number of key issues to illuminate how the Act is being interpreted and being made to work in 1995. The following chapter sets out the some of the problems of the current system which have been highlighted in our evidence. The final chapters look to the future.

The objectives of the Act

19. Fortunately the objectives of the Act and of the financial regulatory community generally are becoming more clearly defined as the SROs come to terms with their market places. This is the case on both the retail and wholesale sides of the market where cost-effective investor protection is now held up as the key objective. In the Report by Prof. Gower which preceeded the Financial Services Bill[16] it was recognised that an appropriate balance between market freedom and investor protection needed to be struck and Professor Gower proposed that the guiding principle should be that "regulation in the interests of the latter should be no greater than is necessary to protect reasonable people from being made fools of." The Government shared Professor Gower's concerns that the new regulatory structure should not seek to provide an all embracing protection for investors, against their own misjudgments as well as those of service providers, and stated in the 1985 White Paper that "the regulatory framework... gives prominence to the time honoured principle of caveat emptor. But it recognises that caveat emptor alone is not enough. For investors to have confidence to venture into the market, measures are needed to reduce the likelihood of fraud and to encourage high standards in the conduct of investment business". Thus while the authorities would concentrate on preventing fraud and dishonest selling they emphasised that investors bore a large part of the responsibility for acquainting themselves with the relevant information to make the best investment they could.

20. While this view is broadly maintained today there has been an important shift in emphasis. The regulatory authorities appear, in the mid-1990s, to have to come to the view that effective regulation and supervision cannot be passive activities but have to be actively pursued to protect investors, not just from fraud or from various sharp practices but also from blatant mis-selling. Professor Gower's basic premise has not proved to be sufficiently robust to act as a guiding principle for the regulatory system and the SROs now recognise that certain industry practices have to be challenged to give investors the ability to make informed judgements. The PIA mission statement, quoted in the Regulatory Plan 1995, is "To protect investors by the regulation and supervision of the retail investment sector, enabling investors to make properly informed decisions in an open, competitive and innovative marketplace". We welcome this more thoughtful and clearer objective. We note that at the heart of this statement is the recognition that a position of asymmetric information exists in the marketplace which prevents retail investors from easily being able to assess what is the most suitable product for them. Furthermore it is clear that sellers of financial services are competing less on price and quality, as in traditional markets, but more on the methods of sale and promotion - which makes it particularly hard for investors to compare products.

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[15] *Financial Services Regulation: Making the Two Tier System Work*, (SIB, May 1993) para.2, p.8.

[16] *Review of Investor Protection*, L.C.B. Gower, Cmnd. 9125, January 1984.

21. Both the SFA and IMRO also have as the apex of their sets of objectives high standards of investor protection.[17] This means that as well as having stringent admissions policies, the wholesale regulators are involved in promoting and supervising best practice between professionals involved in the buying and selling of financial products, whether on an authorised exchange or over the counter, and in the provision of financial advice. In many respects - as with the retail markets - the emphasis is therefore on freeing up information flows and removing information asymmetries." Evidence from ISDA suggests that caveat emptor alone is not necessarily the most appropriate arrangement, even in wholesale markets where the transactors are all professionals.[18]

22. Good regulation is good for the City. The end goal for the regulatory authorities in the wholesale markets (and here we include the RPBs, the Clearing Houses, SIB and the Bank of England) can therefore be summed up as to "ensure that market users have a high level of confidence that the market is a safe and fair place in which to do business. Markets that command such confidence will naturally attract the liquidity that will serve the best interests of all participants - institutional and private investors, as well as market intermediaries and issuers."[19] Clean, transparent markets are therefore also a key objective and benefit not only the actual investor but also, by inspiring confidence, attract greater numbers of market participants. In this way competent and effective regulation can be of benefit to the "City of London" as well as providing suitable investor protection. Accordingly, the efficacy of the regulatory structure, as well as the efficiency of the regulatory community are key factors in helping to maintain and enhance London's position as the pre-eminent European financial centre.

23. The objectives of the Act have therefore come to be more clearly defined since the Large review. However, while investors may also be aware of these objectives a number of concerns remain paramount:

- Who is responsible for what?
- Is the financial community actually providing impartial "best" advice or are commission payments still guiding advice?
- Are the regulators getting fully to grips with those who transgress the spirit and/or the letter of the law?

Self regulation" in practice

24. The term "self-regulation" has long been used to describe the system of regulation established under the 1986 Financial Services Act (FSA). The Gower Report proposed a system of regulation where those involved in investment business would be authorised to carry out that business either by registration with the Department of Trade and Industry, "or through membership of a self-regulatory agency recognised by it."[20] Professor Gower felt that existing trade associations should form the basis of the new "self regulatory agencies". The rationale for this was the need for practitioner involvement in regulation.[21] The "self-regulatory agencies" emerged as "Self-Regulating Organisations" (SROs)[22] and the SRO remains the main entity responsible for the front line regulation today. Given this terminology and the provenance of the original SROs, it is not difficult to see why the system became loosely referred to as "self-regulation". It is probably incorrect, however, to regard the

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[17] See IMRO Regulatory Plan 1994/95, page 15 and SFA Regulatory Plan 1995/96, page 7.

[18] Q4335-4347.

[19] SIB, *Regulation of the UK Equity Markets*, page 8.

[20] *Review of Investor Protection*, L.C.B. Gower, para. 2.11(c).

[21] Gower noted: "the undoubted advantage of having regulators who are knowledgeable professionals has to be weighed against the disadvantage of their lack (or apparent lack) of independence. And a self regulator's advantage of obtaining warning signals on the "old boy net" may be more likely to be obtained if the roles are combined." Para. 2.04.

[22] FSA Schedule 2.

system, even its original form as true self regulation. Anyone carrying on investment business is required by the FSA to be authorised, either by virtue of membership of an SRO[23] or a Recognised Professional Body[24] or by direct authorization by SIB.[25] This means that statutory authority is given to regulation, and that regulation can only be carried out with such authority; in this sense the financial services industry does not have "pure" self regulation but rather self-regulation within a statutory framework.

25. Despite this accepted clarification of the concept of "self regulation" the regulators feel it necessary to re-enforce the message that the system as it now operates is not in fact based on the principle of "self regulation". Mr. Nunneley, the Chairman of the Investment Management Regulatory Organisation (IMRO) commented : "Self regulation does not really exist unless you mean regulation which is paid for by the industry. It is one of the crosses we have to bear that everybody talks about self-regulation as though the industry was running a trade association in a self-interested way."[26] The SFA presented a similar view: "In reality, the "self-regulators" have become statutory regulators in all but name, drawing their power from the fact that it is illegal to operate without becoming subject to their authority."[27] To reflect (or prove) this situation, the SFA has recently renamed its "Membership" department "Authorization". According to an SFA memorandum : "This reflects a new general policy to seek to minimise the profile of SFA as a self-regulatory organisation, and instead seek to project an image of an independent regulator. Identification with self-regulation is becoming increasingly unattractive and, in the Board's view, detrimental to our projection as an effective regulator."[28] The Personal Investment Authority (PIA) also played down their self-regulatory credentials. Mr. Palmer, the Chairman of PIA told the Committee : "If by self-regulation one means something like the BMA where regulation is entirely run by practitioners for practitioners clearly we are not providing that. The constitution of the Board and the way in which we operate militates against that but we are certainly operating within a statutory framework ... That is the perspective I would give of the kind of regulation we are providing and if you pressed me to say "Is that self-regulation?" it is not in the strict sense."[29] **The evidence we have received from the regulators has therefore stressed that the term "self regulation" is a misnomer and fails to reflect their independence or the statutory basis of their authority.**

26. The likely problems with a "self-regulatory" regime were predicted by Professor Gower in his report, and his fear that the regulators' "lack (or apparent lack) of independence"[30] could be a disadvantage of the system appears not yet to have been adequately resolved. Indeed the Large Report recorded as one of the key criticisms of the system that "self regulation equates with self interest."[31] It is clear from the evidence we have received that the regulators fear that this view remains current in 1995. IMRO felt that : "The description of financial services as "self regulation" continues to be interpreted by many as meaning "self interest ..." and " ... it is evident that the perceptions related to self-regulation are still largely negative."[32] Key questions for the regulators to tackle are why have these perceptions arisen and why do they persist? The line of argument from IMRO and the SFA is that these perceptions are in fact mistaken and that the system of regulation established under FSA is actually operating very effectively.[33]

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[23] FSA Part I Ch. III sec.7.

[24] FSA Part I Ch.III sec.15 - The Recognised Professional Bodies give authorization to professionals such as lawyers and accountants who give investment advice as an adjunct to their usual business.

[25] FSA Part I Ch.III, sec.25. The power of recognition is delegated to a designated agency (The Securities and Investments Board) under Part I Chapter XIII sec.114 of FSA.

[26] Q5249.

[27] HC 1994-95, 332-xi, p.255, para.4.

[28] Unprinted memorandum.

[29] Q5374.

[30] *Review of Investor Protection* L.C.B. Gower, Cmnd.9125, January 1984, para.2.04.

[31] *Financial Services Regulation: Making the Two Tier System Work*, (SIB, May 1993), p.8 para.2(ii).

[32] HC 1994-95, 332-xi, p.244, para 7.

[33] See for example Q5302 and Q5356.

27. The regulators' view that public perception is at variance with reality is understandable as they have been making considerable efforts to improve the system of regulation in recent years, especially following the publication of the Large Report in 1993. The Committee recognise and welcome these efforts. Nevertheless, there must be some reason for the negative perception of regulation to have arisen and it is rather unfair of the regulators to dismiss the public as simply being out of touch with reality. In recent years, a series of scandals in the financial sector have tarnished the regulatory regime - indeed the Maxwell case prompted the Large Review. There is also public perception that even when wrongdoing is discovered the authorities seem unable - for a variety of reasons - to convict and punish the perpetrators to a degree that would act as a deterrent or to provide prompt remedies to the victims of fraud or mis-selling. Furthermore a number of recent events in the financial sector can hardly have served to strengthen the position of the regulators. For example the revelation of the Knight Williams debacle, the extent of pension mis-selling and the Office of Fair Trading Report on mortgage repayment methods indicated that "best advice" was not necessarily being given as the salespeople were often overly influenced by the commissions available. In the light of such experiences and the impunity all too often granted to major fraudsters **it is perhaps not surprising that public perception remains unfavourable towards the current regulatory regime by whatever name it is known**, and the current arrangements for the protection of investors against fraud and malpractice. Such a perception may have therefore contributed to the air of disquiet that now surrounds the purchase of personal financial services. Indeed many large financial groups have in recent months confirmed that sales of life assurance and pensions continue to be well below sales of just two years ago.[34] There is according to the Financial Times : "an increasing reluctance by customers to take on long-term commitments, and particular concern about standards of selling in personal pension business."[35]

28. The evidence received by the Committee indicates that Mr. Large's hope - expressed in his 1993 Review[36] - that there would be a significant change in the public perception of regulation has not yet been fulfilled. The regulators assert that the system of regulation now in place is effective and that public doubts about the regulatory regime are mis-placed. The Committee notes with interest that one of the steps in the process to try and restore confidence in the system is the attempts of the regulators to alter their own structures away from "self regulation" because, presumably, investor protection requires a more stringent system than one derived from such a guiding principle. What we have in fact is more a system based on "statutory regulation with professional involvement" than on pure self-regulation. This is important because it means that the original balance which Professor Gower tried to establish between investors and the industry has shifted. It implies that the regulators recognise that a more hard nosed approach to regulation and supervision of financial services is needed and we welcome this development. Nevertheless the Government and the regulatory authorities need to recognise the deep unease felt by many people towards involvement with the financial services industry. **At a time when welfare reforms are likely to see greater calls on the private sector to provide varieties of savings and investment products and social insurance it is vital that the Government gets the financial system right now. The regulatory structure therefore needs to evolve further to meet the current demands being made of it and to ensure adequate investor protection in the complex and multi-faceted financial service markets of tomorrow.**

How SIB and the SROs function

29. The current structure of regulation in UK financial services was originally outlined in the Gower Report, although Professor Gower was equivocal about the need for a "self-standing Commission"[37] ; this nonetheless later emerged in the legislation as the "designated

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34 Prudential - see Financial Times 19 April 1995, Britannia - see Financial Times 12 August 1995, Royal Insurance - see Financial Times 11 August 1995.

35 Financial Times, 19 April 1995.

36 See above Q67.

37 *Review of Investor Protection* L.C.B. Gower, Cmnd. 9125, January 1984, para.3.16.

agency".[38] The position now exists with HM Treasury as the Department responsible for financial services regulation;[39] the designated agency - Securities and Investment Board (SIB) - as the coordinator of regulation answerable to the Treasury; and beneath SIB a series of "recognised bodies" responsible for front line regulation in their particular sector. The key recognised bodies are the "Self-Regulating Organisations" (SROs); the Securities and Futures Authority (SFA), the Investment Management Regulatory Organisation (IMRO) and the Personal Investment Authority (PIA). Also answerable to SIB are the Recognised Investment Exchanges (the markets where products are traded, such as the London Stock Exchange), the Recognised Professional Bodies (regulating professionals such as lawyers and accountants who give investment advice as an aside to their usual business) and the Recognised Clearing House. The majority of transactions covered by FSA are regulated by the three SROs and the Committee has therefore focused most of its evidence on these bodies.[40]

30. The evidence presented to the Committee has reflected a wide diversity of opinions on many matters but there is unanimity that the financial sector has undergone fundamental change since the Gower report first outlined the basis of the current regulatory structure in 1984. Miss Bowe of the PIA asserted that : "In the ten years since the legislation we operate under was a Bill in front of this House *the market place has changed out of all recognition*."[41] As a result, regulation has also altered and developed through time. The purpose of this section is to review how the SIB and the SROs now function in meeting their obligations.

31. The Financial Services Act gives various powers to the Secretary of State responsible for regulating the industry (now to HM Treasury). In practice, many of these powers are delegated to SIB under Chapter XIII of the Act. Despite the statutory basis of SIB's powers, the regulators have praised the flexibility of the Financial Services Act in allowing SIB and the regulatory regime generally to respond to the changing demands of the market. Mr. Whiting of the Treasury told the Committee :"I think one of the great benefits of the Financial Services Act is that whoever drafted it and for whatever reasons, it is amazingly flexible. It is certainly flexible from the regulator's viewpoint in that you can do things and you can change things without having to change the primary legislation."[42]

32. The emerging role of SIB was described *in extenso* in the Large Report : "SIB's activities during the period [since the passage of the Act] concentrated on policy (rule writing, and the recognition and organisation of the regulatory bodies) as opposed to supervision (regulating the regulators and enforcement)."[43] The Report recognised however that a crucial change was needed: "Having set the standards of regulation of recognised bodies, SIB must then ensure that those standards are delivered. That will require significant changes in SIB's own approach to, and techniques of, supervision. ... SIB must accordingly move comprehensively to more systematic and firm methods of supervision of all recognised bodies."[44] In recent evidence, Mr. Large described SIB's current functions as : "being a supervisor of the recognised bodies, a reluctant regulator of certain firms whom we still have to regulate, a regulator in one sense of enforcement as and where we use our powers themselves ... and as far as the strategic aspects are concerned, we do see ourselves as responsible; first of all trying to make sure that we have a coherent approach to the way in which regulation is being conducted across the financial services arena; and secondly, ... also how that relates to the banking regulators and the building societies regulators and in the insurance area as well."[45] SIB has therefore been trying to redefine its role within the

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[38] FSA, Part I Chapter XIII sec.114.

[39] Ministerial responsibility for regulation in all sectors other than the insurance industry was transferred from the DTI to HM Treasury immediately after the 1992 General Election (Transfer of Functions (Financial Services) Order 1992, No.1315).

[40] Oral evidence was however taken from the ICAEW, LSE, LIFFE.

[41] Q5377 - added emphasis, See also Q5629.

[42] Q5176.

[43] *Financial Services Regulation: Making the Two Tier System Work,* (SIB, May 1993), p.9, para.7.

[44] Ibid.p.46, paras 4.6 and 4.7.

[45] Q5724

regulatory system in an attempt to match the regulatory structure to the structure of the market place.

33. While SIB has been evolving so have the SROs. The number of active SROs has reduced from 5 at the time of the passing of the Act to the three at present, and the way in which the SROs view and perform their duties has also changed. The PIA described a similar process to that experienced by SIB with a change in emphasis from regulation to supervision; Mr. Palmer told us : "I feel that as a new regulator we have had to give a lot of weight during our first year and preceding that to matters of regulation and establishing the staffing and structure required to carry out the supervisory role. I hope that as time progresses, and I think we are already in that stage, we will be switching more of our resources to the supervisory side and will not feel it necessary to apply quite so many resources to the regulatory side."[46] As previously noted the SROs have also stressed that they no longer see themselves as "self-regulators" but as front line "statutory" regulators. This raises an important point concerning the nature of the SRO's power. The SROs are authorized by the SIB under statute to regulate their particular sector of the industry, within guidelines set by the SIB and agreed by the SROs. The exact way in which the regulatory aims are achieved is determined by the SROs on the basis of the contractual relationship they have with their members. This contractual basis of power has been widely praised by the SROs as being a flexible and effective mechanism for ensuring regulatory aims are achieved. The SFA characterised the benefits of contractually based enforcement within a statutory framework as : "Ease of amendment and adaptation to a changing industry and new business techniques and practices; the ability to set the burden of proof at the level of balance of probability rather than beyond any reasonable doubt; [and] flexibility to set penalties which have real deterrent value in the specific context of the financial services industry."[47]

34. The regulators have also stressed that as well as statute and contract, the regulatory regime still benefits from practitioner input. Mr Sharples of the SFA went so far as to regard the firms' compliance arrangements as a "fourth tier" of regulation : "There is a fourth tier. In fact, it is the fourth tier which was the one I was getting more enthusiastic about, which is the actual firms themselves ... there is great advantage to us in putting more and more responsibility on the senior management in the firms themselves to comply with the laws, than us trying to do the job for them."[48] In the retail sector Mr. Palmer told us that the PIA is also "relying very heavily on practitioner input."[49]

35. Nevertheless the three key mechanisms for regulation within the current structure - statute, contract and self regulation - do not interact seamlessly. Conflicts and tensions clearly exist within the regulatory regime and there is concern whether the disagreements can readily be resolved under the current regulatory structure so far developed under the FSA.

Costs and Cost effectiveness

36. In Chapter 7 the Large Report notes that "a very common criticism made during my review was that the present regulatory structure generates unnecessary cost: it is too complex; there is duplication, but inefficiency also arises because of underlaps..."[50] The Report concluded that while strong cost control discipline should be pursued by the regulators some regulatory compliance activities were justified on good management grounds alone. This is a view we would endorse particularly with reference to the need for robust risk management systems[51].

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[46] Q5372

[47] HC 1994-95, 332-xi, p.255, para.5.

[48] QQ5326-7.

[49] Q5374.

[50] *Financial Services Regulation: Making the Two Tier System Work* (SIB, May 1993), page 66, para 7.1.

[51] See here the evidence from Mr Quinn to the Committee Q4193.

37. During our evidence sessions a familiar question was asked of a number of witnesses as to the relative burden of regulatory costs falling on UK firms, operating principally in wholesale markets, compared with their competitors in other financial centres. The tone of the responses may have varied but the general picture was that costs, while an important concern, were not out of line with the UK's major competitors and indeed may be on the more modest side. For the regulators the Treasury claimed "In terms of cost, I think our view is that the regulatory costs in the UK are not out of line certainly with Europe. They are relatively small compared with the United States."[52] and this was supported by the SFA and by a noted group of academics and City practitioners.[53] While members of the banking associations and from other financial organisations did not rally to build a case against the relative costs of the FSA, they nevertheless - and understandably - wanted to stress that rising absolute costs were a major concern,[54] that they feared that regulatory creep and regulatory duplication would contribute additional pressures, and that proper cost-benefit analysis should be undertaken before further regulations were imposed or changes considered.

38. In trying to assess the true extent of the costs of the regulatory structure Large drew a distinction between direct and indirect costs. The tables in paragraph 7.11 (paragraph 7.12 gives estimates for the additional costs of the ICS) of the Large report show the evolution of overall direct costs from 1990/91 to 1992/93. Total direct costs for SIB and the four SROs (ie includes FIMBRA and LAUTRO and not PIA) for the three years were £61.9m, £60.8m and £63.9m respectively. Latest available figures shows that total expected direct costs for 1995/96 are around £75.9m, an increase of over 18 per cent on 1992/93.

Table 1: Staff Totals and Planned Expenditure for 1995/96

	Staff Totals	Planned Expenditure*
SIB	222	£21.7m
PIA	379 ~	£21.7m^
IMRO	179	£13.8m
SFA	248	£18.7m
TOTAL	1028**	£75.9m

Source: Individual Annual Reports and Budget and Fees Documentation
* The planned expenditure totals for the 3 SROs do not include SIB fees.
~ Staff total does not include resourcing of Pensions Unit or Ombudsman Bureau.
^ Does not include expected additional levies for the ICS or Pensions Unit levy.
** An additional 43 staff cover FSA activities at HM Treasury (Q5153)

39. On indirect costs the Large report (para 7.15) noted that "little has been done in this area that is helpful in quantifying (them)". The report therefore recommended that SIB should set about generating more information on the cost effect of regulation. SIB's Management Plan for 1995/96 (see para 29) states that its Cost-Benefit analysis unit will reach full strength during the coming year and sets out a number of issues upon which it can be expected to publish its findings. We look forward to seeing this work.

40. A recent discussion document[55] has attempted to make some estimates of the "regulatory administration and incremental compliance costs" to the IFA sector, and to the

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[52] Mr Whiting, Q5233.

[53] See for example Q5331 and the Tables in Chapter 4 of The City Research Project: The Competitiveness Position of London's Financial Services referred to in evidence published as Cm 533, Q79.

[54] See Sir Nicholas Goodison's evidence Q4405-4411.

[55] Sir Alan Peacock and Graham Bannock, *The Rationale of Financial Services Regulation: Is the current structure cost-effective and working?*

retail investment sector as a whole. Whilst admitting that these are essentially "back of the envelope" calculations and that compliance costs are less easily ascertainable than administration costs the authors, by using ratios derived from interviews with IFAs, produce the following set of ranges for their estimates (see table 2). Assessing whether such costs are in any way excessive is, however, also very difficult. The authors do not themselves attempt to set against these costs the benefits to investors from a robust regulatory regime nor do they put these costs into the wider context of the total value of retail investment sector turnover, or by comparing the regulatory costs with similar costs incurred by other financial service providers.

Table 2: Estimated regulatory administration and incremental compliance costs for retail investment business, 1994 (in £m)

	Direct Costs	Compliance Costs	Total Costs
IFAs	20	80 - 214	100 - 234
Retail Investment Business	34	135 - 296	169 - 330

Source: Op. cit Table A.1

41. Concerns about cost nevertheless continue to be raised in evidence presented to the Committee. In February 1994 Mr Linnell, Group Compliance Officer with Prudential Corporation plc, estimated that "the extra cost of the regulatory system, remembering there are some things which we would do anyway to meet our own standards, is of the order of £7 million and that means employing the equivalent of 80 people, full-time, across the corporation..."[56] A more recent submission by BAT UK financial services makes the point that "The costs of regulation, since the implementation of the FSA, have been great. While many of the changes have undoubtedly been necessary, they have been achieved in a manner which has been wasteful of resources within the industry and increases the cost of products to the investor."[57]

42. Concerns about rising regulatory costs are natural in industries which were not subject to such external charges - apart from modest contributions to their professional bodies - less than a decade ago. And the objective of minimising regulatory cost while maximising regulatory effectiveness is incontestable. But it would be singularly myopic for the industry themselves to resist regulatory changes merely on grounds of increased cost. The causal links between effective regulation, public confidence and commercial success are well established, and it is therefore the industry themselves who have most to gain from the efforts of legislators and regulators to plug the gaps which allow the rogue company or even the single rogue trader to threaten public confidence in the purchase of financial services products. There are some financial products - such as some forms of insurance - which we all have to buy; but for the rest, we are all perfectly entitled to keep our money in the clearing banks or the building societies, or even under the mattress. Moreover, as the Single Market Directives begin to take effect, corporates and increasingly individuals will be free to shop for financial products elsewhere in Europe. The cost of regulation - so long as it is delivered in a cost effective manner - is a price which the UK industries need to pay if they aim to persuade us that they have products to sell which are both desirable and competitive.

43. These considerations apply as much to the small independent financial adviser (IFA) as to the large corporates and mutuals. As already noted we have received evidence from individual companies and from groups representing the IFAs, stressing amongst other things what they saw as the disproportionate burden of costs falling on them, arising both from regulators' fees and from the internal costs of ensuring compliance.[58] We understand these concerns, and note that the regulatory bodies - and notably the PIA - have acknowledged the

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[56] Evidence published as HC(1993-94) 236-i & ii, Q34.

[57] Appendix 8.

[58] See for example Q746.

independents' problems and sought to minimise subscriptions and fees, and to simplify some of the paperwork involved in compliance. But regulation, as it has developed, is needed primarily to protect the investor, and in relatively small companies, with a limited spread of expertise and experience, there is at least as much risk of irresponsible advice or fraudulent practice as in large organisations with extended command structures. Moreover, the smaller the company the greater the risk of financial instability and, accordingly. of the risk to the individual investor (and the various compensation funds) if the investors' money is improperly employed. While the regulators need to be aware of the financial impact of their practices on smaller companies in particular, a dilution of regulatory requirements - and hence of costs - in this sector could both put the investor at greater risk and threaten the reputation of the industry as a whole. While there is little evidence of a sweeping contraction of the IFA sector[59] some decline in the future may be an inevitable consequence of a regulatory regime designed to protect the small investor.

[59] The number of IFAs currently regulated by the PIA lies somewhere between 5,000 (see Ms Bowe, Q5445) and in excess of 7,000 (see Sir Alan Peacock and Graham Bannock, *The Rationale of Financial Services Regulation,* footnote 3, page 5.) In March 1994 the PIA estimated that some 5,600 IFAs would be seeking membership of the PIA (HC(1993-94), 236-iv, para 3).

III.PROBLEMS WITH THE REGULATORY REGIME

44. This section of the Report analyses various difficulties within the regulatory structure which have been drawn to the attention of the Committee during the course of the inquiry. Some of these are problems specific to the operation of the system developed under the Financial Services Act while others are of a more general nature. In his 1993 review Mr. Large drew attention to several key difficulties with the regulatory system, and in some instances it is evident that the problems perceived two years ago remain unresolved.

Tensions within the Regulatory Structure

45. The system of regulation established under the FSA has a series of tiers with responsibility and accountability passing between different levels in the structure.
One of the key tensions drawn to the Committee's attention is the nature of the relationship between the SIB and the SROs. Following the Large Report it became clear that SIB would make use of its statutory powers to increase its supervision of the SROs. At the time the industry in general, and IMRO in particular, was trying to accommodate the lessons of the Maxwell Case, and a more proactive and intrusive SIB was no doubt welcomed. Two years on the ground has shifted somewhat and now IMRO, together with SFA and PIA are critical of the role of SIB in supervising the SROs. IMRO in their memorandum felt that : "the role of SIB in closely supervising frontline regulators is increasingly untenable."[60] The SFA were rather more guarded but the same point emerges : "The Act ... creates a three tier structure. This is susceptible to wasteful overlap and competition rather than efficient complementarity, and to confusion about respective rules and who is to be held accountable for what."[61] Mr. Palmer of the PIA also felt that the relationship between SIB and the SROs was a matter of concern : "I think there are things that can be done about managing the interface between the layers that could well help and there are certainly aspects of that that we have raised with the SIB."[62] It is not entirely clear whether this is criticism of what is required of SIB under the Act, or the way in which SIB chooses to carry out the duties given to it under FSA. In the case of the former, the solution would be a redefinition of this aspect of SIB's role in the legislation, in the latter merely (another) review of the way SIB operates. It is not difficult to understand why SIB should choose to use its statutory powers to supervise the SROs. SIB remains ultimately responsible for regulation and supervision carried out by the SROs and is surely therefore entitled to take a close interest in what the SROs are doing. As Mr. Large pointed out in evidence to the Committee, it is only 19 months ago that IMRO was a candidate for de-recognition as an SRO,[63] so it is not unreasonable for SIB to vet closely its operation now. In later sections we will consider possible changes to the structure of regulation and the extent to which this particular area of conflict might be reduced.

46. Apart from this key area of conflict - or potential conflict - in the functioning of the regulatory regime we have also received evidence on the other problems concerning the functioning of the regulatory bodies. An area of importance to SIB is that of direct regulation. The right to direct authorization by HM Treasury (in practice delegated to SIB) is given in the FSA.[64] Although most organisations gain authorization through membership of a recognised body, some are still directly regulated by SIB. This is a task from which SIB has made it policy to withdraw and in the year 31 March 1994-5 the number of directly regulated firms fell from 68 to 39.[65] SIB is a "reluctant regulator"[66] of these firms as

[60] HC 1994-95, 332-xi, p.243, para.5.

[61] Ibid. p.255, para 8.

[62] Q5390.

[63] Q5654.

[64] FSA s.27.

[65] The SIB Annual Report for 1994-95, p.59.

[66] Q5724.

direct regulation means that firms carrying on identical business may be regulated in different places. This provides scope for variation in regulatory standards and could encourage "regulatory arbitrage" if one source of regulation is deemed to be less stringent than another.[67] Furthermore, the requirement to maintain a direct regulatory team means that resources are deflected from SIB's main task of supervising the frontline regulators. It appears that under the current legislation SIB will be unable to withdraw from direct regulation and **the Committee share the view of SIB that in any review of the legislation the right of direct regulation should be removed.** This is in keeping with the conclusions we reached in the publication of our interim report on the retail sector.[68]

Confusion of responsibilities

47. Two particular products examined in some detail during our inquiry - the sale of Home Income Plans, and trading in Derivatives - have illustrated problems inherent in the current regulatory framework. Evidence on these products has underlined that when a new product is developed and traded which falls between different regulators two particular difficulties may arise: either no-one accepts overall responsibility for regulation and so "buck passing" becomes the norm, or so many different organisations proffer their opinion that institutions feel overloaded with directives and codes. The examples discussed here show the regulatory system under some stress arising from this kind of demarcation problem.

Home Income Plans

48. The Committee has taken a large volume of evidence on Home Income Plans (HIPs),[69] the first hearing having been held in February 1994. While the Committee has not launched its own specific inquiry into the sale of HIPs we continue to receive evidence on this topic and remain concerned that there are still such a large number of loose ends remaining. The recent hearings with SIB and with the West Bromwich Building Society highlighted a number of issues germane to our main inquiry.

49. In most cases a typical home income plan involves using the proceeds of a mortgage to acquire a financial asset rather than a building. The asset in question comes under the FSA, the liability does not. This immediately muddies the regulatory waters for the customer/investor and makes seeking compensation in the event of anything going wrong exceedingly complicated. As the SIB submission notes "In March 1992 SIB announced a "one-stop procedure" to deal with HIP complaints involving independent intermediaries. This involved the co-operation of the Building Societies Ombudsman, the Building Societies Commission, the Insurance Ombudsman's Bureau, the Solicitor's Indemnity Fund, the Law Society, FIMBRA, LAUTRO, the Investors Compensation Scheme and the Chartered Institute of Arbitrators (who administer FIMBRA's arbitration scheme)."[70]

50. Furthermore, clarification of where liability for the difficulties encountered with HIPs should rest has proved very time consuming and we appear to be not much nearer establishing the facts of this particular episode - for instance the exact role of the building societies in the introduction and marketing of the schemes - than we were twelve or eighteen months ago. SIB have assured the Committee that they are continuing to look into this case.

51. There are two important lessons that we draw from this episode:

(i) The regulatory framework set up under the FSA was not able to foresee the remarkable variety of financial products now available and therefore attempted to draw too fine a distinction between them. Furthermore it marked out institutional

[67] See for example Q35.

[68] HC 1993-94 236, para.66.

[69] The submissions from the West Bromwich Building Society (27 March 1995, Cmd 346-i) and SIB (29 March 1995, Cmd 346-ii) contain more detailed background material on this issue.

[70] HC(1994-95) 346-ii, p.30, para.9.

boundaries which no longer reflect what is happening in the market place. Creating, promoting, and selling new tailored products which involve both the creation of assets and liabilities - eg the packaging of loans to form marketable securities - which cross the banking, securities and insurance boundaries, and which may use derivative instruments to change risk profiles has led to regulatory gaps or loopholes which are detrimental to investor protection. Part of the problem may lie in the structure of the Act (with its emphasis on how a product is sold rather than what is sold), but part may also lie in the institutional inertia which prevents the regulatory bodies from actively proposing a more complete regulatory framework.

(ii) A further point relates to the length of time that it takes for the regulators to investigate problems in product design or of professional behaviour. For example it is now at least five years since SIB became concerned about the selling of HIPs and while many of those investors that were mis-sold have received some compensation many questions remain unanswered. The Committee regard this kind of delay as unacceptable. **Confidence can only be promoted by prompt public disclosure of evidence against those accused of misdemeanours, effective prosecution and deterrent punishments.** Clearly the regulators will want to be absolutely sure of their case before they proceed to the Courts or take internal disciplinary measures but they must find a way to ensure that the public are kept informed about what is happening and set deadlines as to when action will be taken. It is the transparency of the investigative process that needs to be improved.[71] We welcome the establishment of the "Early Warning Unit" at SIB and look forward to taking evidence on its operations. Nevertheless **we think that the Government should propose revisions to Section 179 and 180 of the FSA with a view to improving the transparency of disputes procedures.**

52. Although the Committee has taken considerable evidence on HIPs, it is important to see this problem in context. A far greater problem in terms of the scale of mis-selling and the likely amount of compensation payable is the issue of mis-selling of personal pensions. In October 1994, SIB published guidelines on the review and compensation process for investors who received poor advice, identifying priority groups of people who had opted out or transferred from occupational pension schemes on the basis of advice from companies regulated under the Financial Services Act. More than 500,000 pension transfers were sold between 1988, when they first became available, and October 1994 when SIB announced details of the review process,[72] and estimates of the level of compensation payable by the whole industry are as high as £4 billion.[73] The PIA, which regulates most of the firms involved in the mis-selling of pensions is now co-ordinating the review procedure, although recent reports[74] have suggested that some companies, particularly the IFAs, are dragging their heels in the review process. **The Committee is concerned, not only that the regulatory regime failed to prevent the large scale mis-selling of pensions, but that the process of identifying and compensating those individuals who received bad advice may be subject to unacceptable delays.** The fact that the task of identifying those individuals who received poor advice and calculating the level of compensation is difficult and onerous does not absolve the regulators and ultimately the firms from providing swift and full recompense for their actions. **The Committee will continue to follow the progress of the review process closely and may wish to return to this issue in future.**

[71] We note with interest para 17 and 18 of the SIB memorandum on "Disclosure of Regulatory Information" (Appendix 19) which refers to the ability of SIB to "express its own view" and to disclose information where it has obtained the consent of each person to whom the information relates and of the person who provided the information. We expect SIB to take advantage of these powers in order to improve the transparency of the investigative process.

[72] Financial Times, 24 October 1994.

[73] Financial Times, 19 July 1995.

[74] Financial Times, 20 September 1995.

Derivatives

53. The Committee has taken a great deal of evidence on derivative trading which has proved to be of value not only in considering the regulation of financial services but also as useful background material for our inquiry into the collapse of Barings. We have focused on a number of issues:

* the prudential regulations that set the parameters for banks' involvement in such trading, which includes the need for sophisticated risk management systems;[75]

* the need for an updated set of accounting standards to adequately measure and promote disclosure of off-balance sheet activities;[76]

* the on-going process of attempting to establish an international regulatory framework within which not just derivative trading but all capital market operations will take place;[77]

* the nature of the relationship that develops between buyer and seller of derivative products be they traded between financial institutions or between financial institutions and corporate clients.[78]

54. On the first issue we note with some concern that best practice recommendations for risk management is an area where the regulators appear to be very cautious about getting too involved, preferring to rely upon trade associations' working groups. Yet this is clearly an area of major concern, as highlighted in two recent surveys (by Touche Ross "Risk Management Systems for Financial Institutions, Benchmark Survey"[79] and Ernst and Young "Derivative Usage by Investment Funds") Mr Jenkins of the Futures and Options Association said that "I think we are taking it (to promote and encourage best practice) seriously. It is probably the highest priority of all the activities that the Association is currently undertaking."[80] The problem with such a trade association code is that it is voluntary and that those financial institutions which are not members of the FOA presumably feel no compunction to adopt the code. There appears to be no formal mechanism to effectively police adherence to the code nor to punish those who transgress its requirements.

55. Furthermore, we were made aware that there are a number of other sets of guidelines laid down by the G30, the General Accounting Office, the Derivative Product Group, and the Bank of England; SIB and the SFA also have working groups on derivatives which may in turn produce their own codes of conduct. These are all voluntary guidelines and clearly no one UK regulatory body is ultimately responsible for producing a set standard of best practices. Given the importance which the regulatory community attaches to the need for proper internal risk management we believe that there is a certain degree of complacency in its approach to setting standards in this area. Indeed Mr Quinn agreed when giving evidence that if an institution did not have the computer systems to adequately measure risk, and to measure its exposure, then it should not be allowed to trade.[81] Obviously firms need time to put in place robust risk management systems, and while any code or set of guidelines may need subsequent revision it must nevertheless be possible for one regulatory body - say the SFA - to be ultimately responsible for producing and policing such guidelines.

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75 Professor Tew (Appendix 14) refers to the development of the latest value at risk, or VAR, models.

76 See Appendix 6.

77 A summary of recent accords, principles and guidance on derivatives regulation was provided by Professor Christopher Johnson (Appendix 16).

78 QQ4335-4347.

79 For example Touche Ross found that 58% of firms surveyed stated that their systems did not meet current market risk requirements, p.1.

80 Q3719 (although at the time of giving the evidence the FOA had not then published its guidelines, they have now issued a consultation document).

81 Q4193.

56. The problem discussed above highlights the difficulty with important areas of best practice where **the lead role of one body within the regulatory community is not clearly defined.** The Committee believes that **the public interest is best served by a regulatory community where responsibilities are clearly set out and recognised and which does not rely on the financial community it is supposed to be regulating to set the pace for defining behaviour in key areas of market practice. Such an objective may only be achieved, however by a wider re-definition of responsibilities - if necessary, through amending legislation.**

57. Relating to our second area of interest the Committee has also been interested in developing a dialogue between financial institutions and regulatory bodies as to what extent shareholders and customers should be aware of the extent of their institution's involvement in derivative trading - in terms of capital committed and reliance upon derivative trading (be it for hedging purposes or proprietary trading) for bottom line profits. The exchanges between the Committee and Sir Peter Middleton, Chairman of BZW, help to illustrate how profitable dealing activities can be for financial institutions.[82] The BBS report into the collapse of Barings Bank also showed how a bank can become easily seduced by what appears to be easy money from derivative trading to boost overall profits and executive bonuses.

58. Nevertheless the banking community is only moving very slowly to provide greater disclosure of its derivative activities.[83] As the Bank of England protested in its submission to the Committee,[84] stripping out speculative profits from hedging profits is difficult and costly to do. Nevertheless the Committee believes that customers are entitled to know the extent to which risks are being taken with their money to generate profits for shareholders and boost the bonuses of directors.[85] As a first step along this path **we recommend that the banking community should accept and readily implement the recent British Banking Association's draft Statement of Recommended Practice.** This includes, among other recommendations, the requirement that greater qualitative disclosures (including detailed explanation of the bank's use of derivatives, description of its trading activities, and discussion of how derivatives are used in asset and liability management) should be undertaken and that a breakdown be given between derivatives held for trading and non-trading activities. **The Committee also recommends that steps should be taken by all banks to reveal the extent to which proprietary trading profits have contributed to overall profitability.** We also consider that the practice of paying individual bonuses from proprietary trading profits may be risky, and we intend to return to the matter in future inquiries. **If the banking community continues to show unwillingness or reluctance to respond fully to the need for full disclosure, there will be inevitable pressure on us - and on HM Government - to impose limits (or even a total ban) on own-account trading by UK institutions.**

59. The evidence sessions on derivatives also brought into sharp focus **the need for and the difficulty of establishing an international regulatory framework in a market which operates continually across national jurisdictions.** Important aspects of this framework include robust and enforceable multilateral codes of conduct and best practice and regular, secure and confidential dialogue between regulators and supervisors in different countries. **The evidence which we have received so far in relation to the collapse of Barings Bank reinforces our suspicion that such codes to date have worked more effectively on paper than in practice: we intend to look at this matter further in future evidence on Barings and on the supervision and regulation of banking institutions.** We believe that it is vital for investor protection and consumer confidence (especially given the growth of the large financial conglomerates[86]) that regulators continue to make great efforts to develop such a framework and to expand and deepen relations with other regulators. The UK in particular

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[82] Q4680-4702.

[83] The BBA brought to our attention the annual accounts of Barclays, Nat West and Deutsche Bank as being good examples of current best practice in disclosure of derivative activity.

[84] Appendix 4, Paras 7-8.

[85] Papers from Professor Goodhart and Professor Dale (Appendix 10 and 11 respectively) explore in detail the issue of "ring-fencing" depositors funds to prevent their use in securities activities.

[86] A financial conglomerate is defined by the Basle Committee as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors (ie banking, securities and insurance)".

has an important role to play in the development of international cooperation in financial services both because of its leading role in Europe in most sectors and because of its long experience. However, we question whether the current UK regulatory structure is necessarily conducive to encouraging such cooperation, for, as Mr Sharples put it, "I find that as I travel round the globe at various conferences....there is confusion from the outsider looking in as to who in the UK is responsible for what."[87] **Establishing clear domestic lines of responsibility will go a long way to improving the ability of regulators to deal effectively with their opposite numbers abroad.**

A definition of "Financial Services"

60. The problems faced by the regulatory system in dealing with products which do not fall clearly within the remit of one regulator come to the heart of difficulties rooted within the Act itself. The Act aims to achieve investor protection and fair dealing by focusing upon how a product is sold, rather than specifying what is sold.[88] Witnesses regarded this as being a benefit of the system, as it made the system of regulation flexible[89] and able to respond to product and market innovation.[90] There is validity in these arguments and there can be no certainty that a more prescriptive system defining what a product should look like would benefit the industry or the consumer. The Act does, however, define what constitutes an investment[91] and is therefore covered by the legislation. This to some extent limits the regulators as to what particular products they are responsible for, although as we shall note later, the SROs have spread their regulatory net through the use of contracts with member firms. **The key exclusion from the Act is lending**. As a result, as the case of Home Income Plans shows, hybrid products - which include a lending and an investment element - can be poorly regulated.

61. Furthermore, the exclusion of lending from the Act means that the decision on mortgage choice, which for many individuals is the major financial decision of their lives, is not regulated under the Financial Services Act. The Office of Fair Trading Report into Mortgage Repayment Methods, (published in April 1995) identified this as an area of particular concern. The report highlighted that the preponderance of endowment mortgages (which now make up 60% of the mortgage market) may reflect advice on mortgage repayment choice which was influenced by the commissions available rather than by a "best advice" requirement. The report concludes that there is a need for advice on the choice of mortgage to give greater consideration of all the factors that impinge upon the suitability of a particular choice and that a "best advice" code should be introduced. Although this move would encourage a higher quality of advice on mortgage repayment choice it might also lead to the kind of regulatory confusion which applied to the sale of Home Income Plans, where separate elements of a packaged product were regulated in different ways by different organisations.

62. One option would be an extension of Financial Services Act criteria to cover the activity of mortgage advice. In their written evidence, the PIA noted that they were considering this option, where the mortgage is related to an investment product (along with other types of financial products including term assurance and permanent health insurance).[92] This raises an important question about how products should be incorporated into the regulatory regime. As noted above, the Financial Services Act dictates which products are subject to the scope of the legislation. However, because of the nature of the contractual relationship between an SRO and its members, it has proved possible to include other products within the current

[87] Q5312.

[88] Q4110.

[89] Q5176.

[90] Q4110.

[91] FSA Schedule 1.

[92] HC 332 -xii, p.268, para.13.

regulatory regime. Miss Bowe of the PIA noted that : "we do have the ability ... by agreement to vary the terms of our contract with our members in order to regulate things which are outwith the Financial Services Act."[93] This mechanism for spreading the area of authority of the Financial Service Act is not one that the regulators are necessarily happy with. Miss Bowe of PIA illustrated this point: "Although in principle we can encompass these changes through variations in our contracts with our members, I think as time goes on that gets less and less satisfactory frankly because the market place changes quite a lot over time."[94] Therefore, the flexibility of the Act has been in some senses a double edged sword. Although this flexibility has been praised as allowing the regulatory system to evolve by the inclusion of additional products (through the use of contractual regulation by the SROs) it is also the case that the more ad hoc approach to the inclusion of products under the Act prevented a more fundamental review of the legislation, which the changed circumstances of the market required.

63. The alternative to spreading the scope of the FSA through the kind of creeping regulation described above would be to reexamine the Act to determine whether the original boundaries determined in the legislation are still appropriate nearly a decade on. The key question facing any such review is whether it remains appropriate for lending to remain outwith the Act. The Committee looked to SIB for guidance on this matter and the evidence supplied indicates that it would be difficult but not impossible for lending to be included within the Act.[95] The evidence from SIB also stressed that this process should not be rushed and could take several years for a solution to be reached.[96] This does not however, absolve the Committee from giving due attention to this problem of the definition of what constitutes a "Financial Service" under the terms of the Act. As Miss Bowe of the PIA pointed out : "There comes a point when we do what we think is right in terms of extending our scope by contract, but I think there comes a moment when it is a matter for parliamentary will whether or not you want to revisit, and decide whether the dividing line as drawn in this piece of legislation is still appropriate in terms of the market ten years on."[97] The fast changing nature of the markets, together with the evidence we have received relating to Home Income Plans in particular, are two reasons why it would appear appropriate to reconsider the scope of the Act. Furthermore, evidence on derivatives has shown the problems which can arise when a particular institution is engaged in areas of business of which the lead regulator has no particular expertise. **On balance, the evidence received by the Committee suggests that there is a need to reexamine the Act to determine whether the definitions of and boundaries between the products and activities covered by the legislation remain appropriate.**

A changing market place

64. The evidence presented to the Committee shows that the functioning of the SIB and the SROs has developed through time and this process is likely to continue given the flexibility of the Financial Services Act. However, it is apparent that the market place will also continue to evolve and that the legislators and regulators will have to try and hit a moving target. Mr. Large drew attention to the fact that the industry has changed markedly over the past 10 years and that "we have today banking and securities activities — and increasingly insurance activities — intermeshing with each other. ... where as a result of the liberalised institutional environment you have a very significant amount of risk management taking place on a global basis, I was suggesting that unless the way regulation is organised is itself able to reflect the way the business is done, that the expectations that will be had of the regulators will be difficult to fulfil."[98] For the head of the key regulatory body to be talking in such terms

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[93] Q5377.

[94] Q5377.

[95] Q4057, 4058, 5722.

[96] Q5722.

[97] Q5377.

[98] Q5629/5631.

shows that this is a serious difficulty, and one which extends beyond consideration of the details of the Financial Services Act, to the search for a more fundamental vision of the shape of regulation in the 21st century.

65. We can clearly identify two particular challenges facing the regulators. First, that the financial services industry is increasingly spreading across geographical borders, which requires a high degree of communication and co-operation between regulators in different parts of the globe, often with different approaches to regulation. Mr. Jerry Corrigan of Goldman Sachs (formerly Governor of the New York Fed) observed that : "the cross border character, by virtue of all its facets of banking and finance, is growing very, very, rapidly; ... So while progress has been real and has been substantial, we do need to achieve a still greater element of co-ordination and harmonisation."[99] One of the difficulties in this area is deciding where the lead should come for this co-ordination and at what level it should take place. In the case of the collapse of Barings Bank, we were told that overseas regulators - aiming to deal with investors' interests - contacted and had to deal with the SIB in the UK, although the lead regulator for Barings is the Bank of England.[100] This leads on to the second key challenge facing regulators in the changing market place : the blurring of institutional boundaries in the financial sector.

66. Evidence taken throughout the inquiry into financial services has shown that the institutional distinctions in the financial sector are dissolving as firms become involved in a wider range of activities. In written evidence, Professor Goodhart and Mr. Schoenmaker noted that : "the current breakdown of the dividing lines between the previously distinct financial institutions, the resulting fuzziness of the structure of the financial system, has made institutional regulation that much more difficult."[101] Therefore, as institutions operate in an increasing number of spheres, the same organisation may need to be subject to a series of different regulations and - more importantly for the regulator - will be open to risks in a wider variety of sectors. Barings is a case in point. Here Barings Bank was based in London and supervised by the Bank of England. Its collapse resulted from losses in futures trading of a subsidiary company of the group in Singapore, Baring Futures (Singapore) Pte Ltd. It is clear that the Bank of England not only did not have a full and clear understanding of the group's diverse activities but also did not have sufficient contact with regulators in different geographical and sectoral areas in order to effectively supervise the group. It is apparent that at present this contact is not sufficiently developed to tackle the problems that can emerge in institutions with diverse activities. Part of the difficulty in this respect is surely the number of regulators involved, at least in the UK. In evidence, Mr Sharples of the SFA told us that at international regulatory conferences, where such communication is developed : "I have always been embarrassed because we sit round this table and there are two from France, there may be a couple from Germany, three from the United States and usually about ten from Britain : the Bank of England, Treasury, the SIB, the SFA and so on."[102] **The implication is that regulatory diversity in the UK means that it is unclear who the lead regulator is in a particular area or for a particular institution. This confusion is not conducive to the formation of a coherent international approach, where a clear vision of developments in the market and the appropriate regulatory response is essential.**

67. Professor Goodhart argued that "the growth of financial conglomerates does not require, in our opinion, a change in the predominantly functionally based regulatory approach of the SIB and its SROs. In contrast, institutionally based regulators eg banks or insurance supervisors, may need to shift their focus to advanced consolidation techniques to assess and monitor the overall group exposure of such financial conglomerates".[103] In theory this may be a robust assessment but in practice such overall group consolidation clearly calls upon

[99] Q4731.

[100] Q5702.

[101] HC(1993-94) 236-xiii, p.11.

[102] Q5350.

[103] HC(1993-94) 236-xiii, p.12.

expertise across market places and it is not clear to us that the current regulatory structure promotes this. One of the most damning criticisms of the Bank of England highlighted in the report on the collapse of Barings was that the Bank of England granted solo consolidation to Barings without really thinking through the consequences.[104] Furthermore one of the key recommendations for the Bank of England is that it "should explore ways of increasing its understanding of the non-banking businesses (particularly financial services businesses) undertaken by those banking groups for which it is responsible for consolidated supervision, and how those businesses interrelate to one another and to such group's banking businesses."[105] **We are dismayed that the Governor[106] can on the one hand claim that London is the best regulated and supervised market in the world and on the other have to concede that his supervisory staff actually have little real understanding what its charges are up to.** The Bank has acknowledged that it must learn more about the securities business yet there are no details of how the Bank will acquire or develop this expertise. If this is an example of the evolutionary approach that many believe to be in the best interests of investors and firms then we do not believe that such an approach can be fully supported.

68. Any review of the functioning of the regulatory system therefore needs to focus not only upon the internal workings of the system at present, but also the future market environment that the regulators will be facing. **To this end there is the need for one regulatory authority to take the initiative and encourage greater regulatory co-operation, whether through statutory or extra-statutory means, to address the problems thrown up by the blurred sectoral and international boundaries in the financial sector.** At the same time, **responsibility for consumer protection in the retail sale of financial liabilities should be brought within the scope of the Financial Services Act.**

The Retail Sector

69. The Committee agreed and published their Interim Report on retail financial services[107] in May 1994. This Report covered both the general regulatory principles applicable in the retail sector and the specific issue of the establishment of the Personal Investment Authority as a regulator of the retail sector. It is not the intention in the present Report to cover these issues again in detail. There are however, some key topics to which we wish to draw attention.

70. The PIA have gone a long way to meet the expectations and recommendations made by the Committee in May 1994. We were told that the PIA has largely established its regulatory structure and is now focusing more effort on the supervision of firms' compliance with these rules.[108] Also in the last year, PIA has introduced new requirements on status disclosure, which ensure that those advising on, and selling financial products disclose whether they are independent, or tied to a particular firm or organisation and its products. They have also implemented new requirements for the disclosure of commission and charges for life assurance policies. The Committee welcome these moves. There are, however, two particular areas of concern that have emerged in the retail sector : individual registration of staff and the provision of compensation.

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[104] *Inquiry into the circumstances of the collapse of Barings*, Board of Banking Supervision, para 1124.

[105] Para 14.35 op cit.

[106] Newspaper reference end August 1995.

[107] HC 1993-94 236.

[108] Q5372.

Registration of Staff

71. In the Interim Report on retail financial services the Committee recommended that PIA should maintain a register of all individual salesmen and advisers authorised to give retail investment advice.[109] It appears that as yet this recommendation has not been implemented, although PIA have consulted with their members on this topic, as part of a broader consultation exercise. The main objections to registration are that it might add to the cost of regulation,[110] without significantly increasing investor protection. In the light of these objections the Committee are concerned that no efforts to evaluate the cost of this recommendation have been undertaken by PIA to test the validity of the criticism.[111] **The Committee are concerned that resistance from the industry to this recommendation is having undue influence on PIA policy in this area.**[112] The need for independent regulation by the SRO to improve the public perception of the regulatory regime has been stressed in many evidence sessions[113] **and this is an area where PIA should adopt a more independent stance to demonstrate their ambition to achieve investor protection.**

[109] HC 1993-94 236, para.78.

[110] Q5417.

[111] Q5427.

[112] Q5423.

[113] Q5303, Q5356.

Compensation of Investors

72. The second area of concern is the provision of compensation to investors who have suffered as a result of either fraud or poor advice.The Large Report identified this as an area of difficulty, noting that the scheme for providing compensation : "is felt by the industry to be unfair as regards the way that it is funded, and by investors to be too slow and too difficult to access."[114] Recent events have shown that problems still persist. Where the organisation that gave the advice has gone out of business and there are no funds available to recompense the investors, compensation is provided through the Investors Compensation Scheme, which is funded from industry contributions and administered by a private company. The scheme ran into difficulties when one of the contributing companies - Sun Life - disputed the terms on which the scheme is funded. The root of the problem was that compensation is being paid to investors who lost as a result of activities of firms which have either now gone out of business or have not joined the new retail regulator - PIA - and Sun Life questioned why they should be paying for such liabilities. The PIA (and the Investors Compensation Scheme) are therefore suffering as result of the actions of members of the former retail regulators FIMBRA and LAUTRO. Indeed, the financial crisis of the retail regulators was one of the reasons for the formation of a new single retail regulator. This issue shows one of the problems of "regulation on the hoof" where change is introduced as a response to problems rather than as a result of strategic planning. Of greater concern is the fact that **the regulatory system is still struggling to provide an effective and stable compensation scheme.** Indeed, the scheme required a Treasury guarantee in July 1995 to ensure its continued operation, pending the outcome of litigation. Although Sun Life lost the case, and has made it clear it will not appeal, the nature and funding of the present scheme is an area that warrants attention, to ensure that a stable scheme that provides compensation on a timely basis is established. This need will be paramount as compensation for personal pension mis-selling becomes payable following the current review process.

Enforcement and the civil/criminal interface

73. Public confidence in the regulatory system is also being undermined because, as noted in the Large report, "too much fraud goes unpunished." One of the areas that needs to be scrutinised is the enforcement of the standards of investor protection. Enforcement involves the whole range of bodies that make up the financial regulatory community and also the Serious Fraud Office. The Serious Fraud Office plays a pivotal role in assuring the general public that serious financial misdemeanours are dealt with swiftly and punitive punishments handed down, and - however unfair it may seem - the regulatory community's performance does tend to be judged in the light of the successes or failings of the SFO. The evidence taken during this inquiry indicates that there is substantial public concern as to performance of the SFO. This relates not only to its effectiveness in convicting fraudsters but also to the appropriateness of the convictions it is able to secure. On the basis of the evidence which we have so far taken, we share the public's concern.

74. Chapter 5 of the Large report sets out what SIB then saw as the key areas of difficulty with enforcement and the direction SIB wanted to move in. The FSA provides a number of statutory powers of investigation and enforcement which are only exercisable by SIB: these include the power under Section 59 to ban individuals from the industry and under Section 60 of the Act the power to publicly criticise authorised persons. As set out in its memorandum to the Committee SIB sees its work in this area falling into two camps: policing the perimeter, where SIB deals with those who conduct investment business illegally, without authorization or exemption; and where SIB has to deal with firms that are authorised under the FSA.[115]

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[114] *Financial Services Regulation: Making the Two Tier System Work* (SIB, May 1993), page 14, para 28-ii.

[115] HC(1994-95) 332-xiv, p.332-3, paras 23-32.

75. More generally the Large Report outlined two particular areas where the fit of regulatory enforcement into the general body of law has led to difficulties; these areas remain of concern to-day. The first is what the Large Report called the "vertical" interface between regulatory enforcement and the criminal law. The second is the "horizontal" interface of different agencies with responsibilities for enforcement of interlinked or overlapping areas of misdemeanours.[116]

Plea bargaining in Criminal cases

76. In paragraph 5.15 the Large Report states that "both SIB and the recognised bodies have a stake in the success of criminal proceedings. Resolution will depend on reaching a satisfactory interplay between civil and criminal proceedings, involving such techniques as plea bargaining." The Report goes on to commit SIB to work even more closely with criminal prosecutors through a greater use of plea bargaining. Nevertheless, despite this open statement of intent, plea bargaining as a specific technique which the regulators could use has remained veiled in shadows, and is not a technique which can be fully developed within the current constraints of British criminal legal practice.

77. The Committee is interested in plea bargaining because from the perception of what happens in the United States plea bargaining appears to be a very effective tool in the regulatory armoury in getting people quickly to bring out information and as a means of securing criminal convictions in high profile cases[117] and with significant savings in court time and cost. Nevertheless there are real concerns that (as the Court of Justice has highlighted) plea bargaining which involved sentencing may give rise to miscarriages of justice when confused defendants or defendants who think they are in a weak position actually plead guilty to offences which they had not committed. Furthermore, the lack of influence on the eventual sentence in the UK system may actively discourage the use of plea bargaining in the first place.

78. A variant on the form of plea bargaining was explained to the Committee. Mr Staples explained a form of tripartite plea bargaining "where a criminal case is being brought forward, a plea of guilty is put forward to a lesser charge which might result in a lower sentence than otherwise might be the case or indeed even a conditional discharge but the conditions of the discharge would be regulatory penalties imposed by the regulator if it were a case which involved a regulator."[118] In this situation the criminal and regulatory judicial processes would work in closer harmony than is currently possible in the UK. We note with interest the personal comment made by a senior HM Treasury official as to the potential usefulness of plea bargaining.[119]

The link between regulatory, criminal and civil proceedings: the "vertical" interface.

79. During a discussion of how IMRO's system of plea bargaining (known as the "Settlement Process") works within its regulatory field of civil standards of behaviour Mr Thorpe also addressed the difficulties of the criminal/civil interface. He said that "the regulatory authorities can generally bring prosecuting actions under their contracts with the firms they regulate quickly and can produce results effectively. Where the actions they are looking at cross into criminal prosecuting territory they have to adopt a hands-off attitude and let that process take its course. That has led, I'm afraid, in some instances to prolonged prosecutions and rather poor results. We feel that that has undermined in many ways the effectiveness of the system, or at least the perception of effectiveness."[120] Mr Thorpe was

[116] *Financial Services Regulation: Making the Two Tier System Work*, (SIB, May 1993), para 5.14.

[117] See for example Q5569.

[118] Q5550.

[119] Q5236/7.

[120] Q5271.

thus making a plea for the SROs to be able to make greater use of their regulatory powers to mop up offences in a more efficient and effective manner than is currently possible. The key factor in his argument was the use of the civil burden of proof requirements rather than a criminal one.

80. A possible solution to the problem of how under a civil system to maintain an ultimate sanction was put forward by the London Stock Exchange. Their concern is that there have been cases where "it is almost impossible to get the level of evidence required for criminal conviction in the securities market, because it is so easy to use offshore vehicles and all sorts of other cloaks; so you can sort of "know" who is behind it, but you cannot prove it to the level you need for court conviction."[121] Mr Lawrence went on to outline a practice of the US Securities and Exchange Commission whereby the civil courts can be used to put an individual or firm in a restraint situation and if there is "a further event then it is a breach of the court order"[122] and the criminal law comes into play. **Possible solutions of this kind need to be examined further.**

The relationship between regulators: the "horizontal" interface

81. In discussing the relationship between regulators the Large report set out the stall for a central policeman within the City to oversee a whole variety of areas (eg fraud, market manipulation, and insider dealing). However the report shied away from recommending the establishment of such a body and instead committed SIB to "promote greater inter-regulatory enforcement co-operation." Clearly this problem area relates to our primary concerns that under the current system there is a danger of confusion as to responsibility so that it is possible to have in one particular area of activity regulatory overlap and hence duplication and high cost but also the possibility in other areas of certain actions and behaviour slipping through the regulatory net. We have listened to the comments from the London Stock Exchange that "the problem with a large, monolithic body is not only can it be in danger of getting remote, it can also be slow in its reaction times ..." and that "therefore it [London] needs regulators at the coal face to move quickly."[123] We can not at this stage see great merits in inventing a new body or giving one body such an extensive remit. Nevertheless SIB is to some extent taking on such a role (eg in its attempts to change London Stock Exchange disclosure practices, and in its desire to be able to fine SRO member firms). We would however be more comfortable with a clearer differentiation of responsibilities and any government redefinition of the system should ensure that SIB concentrate its resources on the more strategic and specifically institutional matters (eg such as the operation of the Stock Exchange and how to supervise financial conglomerates) leaving those events linking firms and markets to the SROs which authorised those firms in the first place.

[121] Q5040.

[122] Q5041.

[123] Q5060.

IV MOVING THE DEBATE FORWARD

Drawing Distinctions: Regulation vs. Supervision

82. The structure of regulation of financial services in the UK is a complex one; it is easy to lose sight of basic distinctions and principles in examining the particular forms of regulation which have arisen following the Financial Services Act. We wish to set out four key distinctions in the practice of regulation which, we consider, should be taken into consideration in the formulation of an effective regulatory framework.

83. First is the distinction between regulation and supervision. The distinction between the two has perhaps been most clearly stated by Mr Brian Quinn of the Bank of England:

> "Regulation ... is about rules and about the precise formulation and policing of those rules. In respect of financial services it calls for the codification of a corpus of strictly defined and detailed rules relating to particular activities, products and services. It entails specialised techniques of monitoring and enforcement and is usually accompanied by sanctions which are equally precise in their nature and in the circumstances of their application...
>
> "Supervision is different, both in content and in style: the law sets the framework within which authorised companies may operate, rather than prescribing in detail how the relevant goods and services should be provided. Within that context, the companies providing those goods and services are, broadly speaking, left to make their own business decisions.[124]

It will be seen that these two approaches are not, in practice, mutually exclusive, and that a combination of the two has been exercised by most of the regulatory authorities. A regulatory approach, such as is largely practised by the PIA, might rely on the enforcement of a rule book. A supervisory approach, which the Bank appears to favour, might rely on the prescription of objectives, leaving it to the supervised firm to show to the supervisor's satisfaction how the prescribed objectives will be achieved. Clearly, supervision is a less rigid approach; it may prove less costly, and more suited to a quickly changing environment. An examination of any regulatory framework will wish to see how effectively it provides protection, how objectives can most usefully be framed, and shown to be met, and to what extent a rule-based approach is necessary.

84. The second distinction is that between regulation based on function, and one based on institutions. Whether a single regulator should regulate all the activities of a firm, or whether the different activities of a firm should be divided between regulators according to the nature of the activities, is a question of increasing urgency in view of the increasing range and scope of activities and products engaged in by individual firms. The FSA introduced a largely functional approach to regulation. The current framework, then, largely allows institutional structures to emerge without interference, and does not act to preserve individual institutions. In some areas, such as the regulation of insurance, or the regulation and supervision of banks, where it is considered that the issue of systemic risk requires it, an institutional approach survives. In these areas it is relevant to consider how far institutional regulators have succeeded, or can succeed, in maintaining their expertise in the range of activities offered by an institution under their purview, and how successful a functional approach can be in maintaining clear lines of responsibility and accountability.

85. Thirdly, we distinguish between regulation which is directed at establishing the safety and soundness of an institution, and the regulation of the conduct of business. The first might be concerned with such matters as the continuing solvency of a firm and capital adequacy. The second would examine, to a much greater extent, matters such as the treatment of individual consumers and investors. These are issues of such widely differing nature that at least one of our witnesses thought that neither a purely functional nor a purely institutional

[124] Bank of England Quarterly Bulletin, May 1993, pp.260-1.

form of regulation could hope to cover both matters.[125] There have been several well-publicised disasters and misfortunes in the financial services industry in recent years. We bore in mind the question of how far these embarrassing and conspicuous failings in the regulatory structure could be ascribed to inadequate or inappropriate regulation on either side of this divide.

86. Fourthly, there is an important distinction to be made between the forms of regulation appropriate to a wholesale market, and that appropriate to retail markets. It was clear to us from the outset that there ought to be greater scope for self-regulation and a supervisory approach in a marketplace of professionals dealing with professionals. In particular, we doubted whether it would be sensible to prescribe in detail rules about the conduct of business, and provide a statutory basis for such rules in a professional market, or whether this was an area which could safely be left to self-regulation. The regulation of safety and soundness of such a market, on the other hand, we considered to be an issue of public interest, and saw no reason to consider the responsibility of the regulator in any way diminished by the expertise of every participant in the market. In the case of retail markets, on the other hand, there may be much wider scope for the involvement of the regulator. The question of public interest obviously is quite different in a market where members of the public are directly involved. In this case, it is arguable that the regulation of both business practice and the safety and soundness of an institution could be justified to almost any degree of severity by the claims of the need to protect the public interest, in the form of individual members of the public.

The Role of the SIB and the Regulatory Structure

87. At the heart of the debate concerning the future of the regulatory regime and the continued operation of the Financial Services Act is the question of what role SIB should play. In the course of the inquiry we have been presented with two distinct views of how SIB and the current regulatory system operates.

88. The role of the SIB in the current regulatory structure was outlined above.[126] In evidence to the Committee, Mr. Whiting of the Treasury both praised and defended the role and performance of SIB. He felt that: "within the system we have the SIB carries out a range of functions which no other body carries out. ... if you just abolished SIB overnight, then there would be some gaping holes in the regulatory system which no-one else could fill unless you had a radical change in the legislation."[127] Therefore, according to Mr. Whiting, the abolition of SIB would be "to the detriment"[128] of the regulatory structure. Mr Whiting also praised the balance being achieved between regulation (the setting of detailed rules) and supervision (ensuring the rules are implemented effectively) by financial watchdogs, noting the system is still relatively young in the UK and that "we are certainly moving towards a better balance [between regulation and supervision]."[129] Part of this improvement results from the natural evolution of the regulatory structure, but also reflects a higher calibre of staff. Mr. Whiting felt that "things are improving. My own feeling is that SIB in particular, but also the SROs are now getting some pretty able people."[130]

89. Furthermore, Mr. Whiting praised the regulatory structure that SIB underpins. The criteria he uses to measure the system of regulation and supervision are threefold; "a level of investor protection which we would regard as satisfactory and secondly, to make sure the system is not subject to systemic abuse and thirdly, we look at the integrity of the markets. ... If you are asking me, is the system working sufficiently well, I think at the moment the answer is yes. ... I think it is becoming more effective than it was before. I think at the moment it is delivering through a combination of supervision and compensation a level of

[125] Q8.

[126] Paragraphs 29-35.

[127] Q5132.

[128] Q5132.

[129] Q5124.

[130] Q5125.

investor protection which we would regard as broadly acceptable."[131] It is clear from the evidence presented by the Treasury that in their view the system of regulation and the role of SIB at present are acceptable and sustainable. The redefined role of the SIB - as outlined in the Large Report - as a supervisor of the front line regulators is clearly regarded as sustainable and useful. The flexibility of the Financial Services Act, in allowing the regulatory bodies to evolve and re-define their functions and relationships is at the heart of this process. It may well be that there nonetheless needs to further consideration of the role of the SIB, in particular with regards its relationship with the SROs. Indeed, SIB outlined some of the likely courses of action in this respect : to involve the SROs in discussions concerning how SIB will operate over the coming year; to develop a subsequent dialogue on how the structure might be improved in the longer term; and to seek solutions to current tensions and so enhance the public perception of the regulatory system.[132] The essence of this view is that the current regulatory system can continue - with appropriate evolution - to provide the basis of investor protection and market management in the financial services industry.

90. As shown in section III, there are many tensions and difficulties within the present regulatory structure, and of particular concern is the view expressed by Mr Thorpe of IMRO that: "the idea, legitimate in May 1993, that SIB needed to be intrusive and constant in its supervision of the front line regulators, is redundant. SIB now needs to evolve its role to meet the changed circumstances by stepping back from its current intrusive style."[133] The key question in this respect is whether the SROs are now critical of the way in which SIB fulfils its statutory duties or whether it is the statutory duty itself which is regarded as being flawed. Mr. Large of SIB said: "I think it is probably a combination of the two and as far as each of them is concerned, there are different conclusions that one can draw and different things that one can do."[134] If emphasis is placed on a consideration of how SIB performs its statutory duties then this can be resolved through a consideration of the relationship between SIB and the SROs within the current framework. Mr Large of SIB hinted at this very point: "I have to say I was surprised by the statement (made by IMRO and quoted above) because as little as one year ago in IMRO's annual report, they stated that the way in which we were going about the changes that I had proposed in my review two years ago, which has led to the way in which we conduct ourselves as far as supervision is concerned, they praised that and said that they thought that was going well and something that they were glad to be taking part in."[135]

91. If, however, the SROs are being critical of the statutory duties placed upon SIB then this has more fundamental implications for the regulatory regime. SIB have made it clear that they do not see a different way to fulfil their statutory obligations under the Act other than through the current supervisory processes. Mr Large told us: "Our duties, after all, are to ensure that the recognised bodies are in the first instance recognised and also that they continue on a continuing basis to meet the recognition criteria. Now our Board does not believe that that can be done on the basis of the sort of ex-post audit ... There is a feeling that we need, therefore, to have a significant understanding of the way in which the body is on a continuing basis keeping to the recognition criteria."[136]

92. It is interesting to note the "change of heart" apparent in the attitudes of the SROs towards the more intrusive supervisory stance adopted by SIB following the Large Review (and responding to the Maxwell case). One reason is the undoubted strengthening of the SROs as regulatory and supervisory organisations - indeed this was commented upon by many witnesses - as Mr Large succinctly put it: "Yes, the SROs have become stronger frontline regulators and I think we should regard that as a success rather than a failure. It is exactly

[131] Q5173.

[132] Q5726.

[133] HC 1994-95 332-xi, p.264, para.8.

[134] Q5638.

[135] Q5638.

[136] Q5653.

what we all intended."[137] This increased strength has resulted in the feeling that the SROs "would like to see us (SIB) less intrusive and less big, less involved."[138] Yet it appears there is more to the desire of the SROs to stress their importance and independence than a reflection that they have become stronger organisations. In their submission, IMRO stated: "Some commentators have suggested an eventual integration of frontline regulators with SIB."[139] The fear of this loss of independence and identity must have coloured the frontline regulators' view of the prospects for the regulatory structure. Mr. Whiting of the Treasury felt this helped explain the attitude of the SROs towards SIB, and the regulatory system generally. He observed: "It seems to me to be not surprising at all. I do not think it casts any aspersions at all on the regulatory system we have. *I think it is basically people fighting for their freedom.*"[140]

93. It is clear that current tensions within the regulatory structure - particularly the role of SIB - need to be resolved. The solution depends upon the view taken as to the depth and cause of the problems. In any event it is clear that in-fighting amongst the regulators and the jostling for position in any potential new structure is not helping to enhance the public perception of the regulatory system nor adding anything to the achievement of investor protection. **In the short term the SIB and the SROs should work together to improve their relationship. If this is not achieved, it will be necessary, in the context of the review of the Financial Services Act which we recommend later, also to review the regulatory structure under the existing legislation, and whether there is a need to perpetuate the two "tiers" represented by the SIB and the SROs.**

Evolution or radical change?

94. During the course of our two-year inquiry we have heard almost innumerable criticisms either of the detailed provisions of the Financial Services Act or of different aspects of its implementation. Many of these criticisms have been discussed in our earlier Reports or have been considered in the previous sections of this Report. There is nothing new about some of the general themes underlying these criticisms. Indeed, as early as January 1993, when we first took evidence on the Treasury's new responsibilities, some of the points of doubt and uncertainty about the Act which have become only too familiar during our inquiry were already being clearly articulated by the responsible Minister, the then Economic Secretary to the Treasury, Mr Anthony Nelson MP.

95. Mr Nelson recalled his belief, as a backbencher, at the time the legislation was going through Parliament, that the Act was "something of a fudge", and that it provided for "neither self-regulation nor wholly statutory regulation"; and he concluded that "some of the problems we have encountered subsequently ... have resulted from that rather convoluted fudge". He wanted to see changes in methods of investigation and enforcement "to introduce more fear into the system", and was critical of the "profusion of different SRO's", and of "fragmentation" not only in terms of the number of bodies involved "but also the extent to which banks, building societies, life offices belong to different SRO's". Mr Nelson commented that he would "not be surprised, indeed I might welcome in the course of time, more streamlining and further simplification".

96. At the time he gave evidence Mr Nelson nonetheless argued in favour of an evolutionary approach to regulation under the Act. It would be better "to look to see whether deficiencies which are already apparent can be redressed by more strongly exercising the present framework and other changes, than by coming back to the House at this stage". New legislation might be required at some future stage, but that had not yet been reached. The objective was to get good people into the job and keep them there: "I would far rather have

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[137] Q5725.

[138] Q5641.

[139] HC 1994-95 332-xi, p.244, para.15.

[140] Q5185.

good people running an imperfect system than I would a perfect structure inadequately resourced and staffed".[141]

97. This reluctance to contemplate new legislation has remained a continuing feature of the Government's approach to financial services regulation, and was as evident in the Treasury's evidence at the end of this inquiry as when we began. A reluctance to rush into new legislation is understandable, in view of the uncertainty of the outcome. In this case, the Treasury's reluctance has to a considerable extent been justified, so far, by events. As the responsible Under-Secretary at the Treasury, Mr Alan Whiting, stressed in his evidence, one of the great benefits of the Financial Services Act has proved to be its flexibility; in the years since the Act began to come into operation significant changes in the methods of operation and approach, and the balance of activities between the SIB and the SRO's, have been achieved without recourse to Parliament.[142]

98. But clearly there are pressures within the system itself for change which may be achievable only through primary legislation. At one extreme, changes to reduce the number of separate tiers in the system, or to significantly widen the range of products covered by the Act, would be difficult, if not impossible, to accommodate within the existing legislative framework. But even if the basic structure were to remain intact, there are pressures from the regulatory bodies themselves - and notably from the SIB - for modifications in the statutory powers available within the system to achieve, for example, more effective enforcement. For this reason, **we incline to the view that some amendments to the primary legislation are now necessary, and that HM Treasury's resistance to the introduction of new legislation may no longer be tenable.**

99. In a recent speech the Chairman of the SIB, Mr Andrew Large, acknowledged the variety of tensions and problems referred to earlier in this Report, and identified 1996 (when the industry will celebrate the tenth anniversary of the passing of the Financial Services Act) as

> "the year in which we will take forward the process of analysis and map out the way ahead: the year in which we review experience and draw some conclusions from it. ... The ultimate outcome of this process should take the form of a strategy and an action plan which will be comprehensive - not a patchwork of "quick fixes". In the end it may be taht the changes will be modest. But we will look at all the options and consider the implications of each."[143]

100. This is a very welcome approach from the Chairman of the foremost regulator body in the non-banking sector, and it is to be hoped that it will be welcomed by the other regulators as an opportunity to seek collective solutions to the outstanding problems of the industry. It is in principle, in our view, preferable to the imposition of an ex cathedra review on a structure which has to date shown itself capable of developing and adapting without unnecessary interference from either Government or Parliament. In a year's time it may be easier for us, and for the Government, to assess whether this approach has yielded sufficient fruit, palatable to all, which would obviate the need for any wider, and externally-imposed, review.

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[141] Minutes of Evidence, 20 January 1993 (*The Transfer of Responsibility for Financial Services*), QQ27-29.

[142] Eg. QQ5173, 5124, 5130.

[143] 1995 Britannia Caledonian Financial Services Lecture, 4 October 1995.

V CONCLUSIONS AND RECOMMENDATIONS

101. Our inquiry has been undertaken during a period of rapid change in the financial services industries in the United Kingdom. New products are emerging to cater for new markets and new corporate structures are emerging for the delivery of these products. Government policy has favoured the liberalisation of the industries from artificial legislative constraints and has encouraged greater competition between previously compartmentalised sectors: the distinction between building societies and banks, for instance, has been significantly eroded by Government action during this period. At the same time, public expectations of the regulatory system, and of the compensation available where the rules have been transgressed, have developed - perhaps faster than the delivery capability of the system.

Self-regulation

102. Our inquiry has also coincided with a developing maturity in the approach of the regulatory bodies towards their tasks. From being the apparent creatures of their client industries the so-called Self-Regulatory Organisations established under the Financial Services Act have developed into self-confident regulatory organisations with objectives transcending the particular interests of the industries and asserting the public interest over the particular interests of their members. Indeed, it is indicative of the significant change in the self-perception of the regulators that an SRO such as the SFA should go so far as to abandon the concept of "membership" in its organisation: whatever the Act says, and whatever the philosophy underlying the legislation, the SFA and the other SRO's have now moved firmly towards acting as "statutory regulators with practitioner involvement", and firmly away from acting primarily in the interests of their client industries.

103. This trend away from nominal "self-regulation", and towards an open acceptance of the statutory and enforceable nature of financial services regulation in the United Kingdom needs to be recognised by practitioners and by politicians, and extended to other sectors not directly covered by the so-called SRO's. Under existing legislation, the "self-regulatory organisations" are defined as such under Section 8 of the FSA. Although they will no doubt continue to be referred to as "SRO's" (for want of a better term) the actions of the bodies themselves confirm that the concept of self-regulation is dying a natural death, at least so far as the major regulatory organisations are concerned. **In any future legislation a more appropriate generic term should be employed.**

104. The movement away from self-regulation in theory and in practice in the SRO's is to be warmly welcomed. Schedule 2 of the FSA requires merely that the governing body of each SRO should be composed so as to secure a "proper balance" between the interests of the different members of the organisation and between them and the interests of the public. The "proper balance" is nowhere defined in the Act; this accordingly enables the SIB, as the authorising authority, to determine that balance. The SIB sought to achieve a preponderance of "public interest" members on the Board of the new PIA in 1994, but its initiatives were effectively circumvented by the new body. Given the acceptance by all the SRO's, and the SIB, of the need for a preponderance of public interest Board members, **we recommend that the SIB should now require that the Boards of the PIA, IMRO and the SFA be reconstituted within a reasonable timescale to achieve that objective.**

105. If the three main SRO's, and the SIB, now accept this redefinition of what "self-regulation" means in practice, it must call into question the continued validity of other regulatory bodies either recognised under the Financial Services Act or exempted from the provisions of the Act, where "self-regulation" continues to be applied more in accordance with the letter of the 1986 Act and less in accordance with its contemporary interpretation.

106. It is now widely accepted that self-regulation, in literal terms, is inappropriate in the retail sector, where the priority must be the protection of the interests of the individual private investor. Although the recognised professional bodies (RPB's) only regulate persons who undertake investment business as a secondary activity (such as chartered accountants and

lawyers) the impact on the individual of misleading or fraudulent advice is much the same. We believe that **the SIB - and, ultimately, the Government - need to address the need for changes in the RPB sector of regulation**: either the composition of the regulatory arms of the RPB's (such as the Institute of Chartered Accountants, or the Law Society) needs to be reformed to assure a preponderance of non-practitioner membership, or the activities of these bodies as regulators needs to be transferred to the appropriate SRO - which would normally be the PIA. **We recommend that the SIB should undertake an inquiry to determine the future of regulation through the RPB's, with a view to ensuring that the principle of statutory regulation with practitioner involvement is in future applied to this sector.**

Regulation at Lloyd's of London

107. In one area not directly covered by the Financial Services Act - Lloyd's of London - we have already recommended that responsibility for regulation should be transferred to a wholly independent body operating according to the principles established under the Financial Services Act and refined in practice by the SIB.[144] The Government's response to this recommendation - submitted as a Memorandum from the Department of Trade and Industry - is singularly complacent, and fails to address the urgent need for an early and complete break from "self-regulation" as practised to date by the Society of Lloyd's. The DTI have offered a "longer-term review of the statutory framework of Lloyd's regulation", but not until it is clear that the current structural reforms of Lloyd's are coming into effect.[145] This is, in our view, a wholly inappropriate response to a critical situation which needs urgent attention. **We accordingly repeat our recommendation that legislation should be introduced to transfer to an independent body responsibility for the regulation of Lloyd's according to the principles established under the Financial Services Act 1986 and refined in practice by the SIB. We also repeat our view that the new body should be directly answerable to HM Treasury.**

Banks and Building Societies

108. So far as the UK banking industry is concerned, the principle of "self-regulation" has never been applied so far as prudential supervision is concerned. The Bank of England is a statutory body which is not drawn from the banking constituency; and the Board of Banking Supervision has a preponderance of independent members. The efficiency of the Bank of England as supervisor has nonetheless come into question several times in recent years, most notably in respect of BCCI and Barings, and both the latter cases have given rise to serious concerns as to whether the Bank, as supervisor, is sufficiently divorced from the culture of the banking industry to enable it to operate as a genuinely independent supervisor and regulator.

109. In our earlier Report on the role of the Bank of England, we concluded that there was "no overwhelming case for separating out the responsibility for prudential supervision to a separate body", and that "the balance of argument, as now, will probably remain in favour of maintaining the status quo in supervision even if the Bank gains greater autonomy in monetary policy". We stressed, however, that the position might need to be reviewed "if there were to be a complete reorganisation of banking and financial services regulation and supervision".[146] We have not, in this inquiry, taken further detailed evidence on the continued appropriateness of the Bank of England as the prudential supervisor and regulator of the banking industry. However, we are bound to observe that the report of the Board of Banking Supervision into the *Collapse of Barings*[147] itself raises considerable doubts about the effectiveness of the Bank in this area.

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[144] Fifth Report, Session 1994-95 (HC 187-I), paras. 69-70.

[145] Fifth Special Report, Session 1994-95 (HC 745): *Financial Services Regulation: Self-Regulation at Lloyd's of London: The Government's Response to the Fifth Report from the Committee in Session 1994-95, para.I.26.*

[146] First Report, Session 1993-94 (HC98-I), paras.102-3.

[147] Session 1994-95, HC673.

110. **We recommend that HM Treasury should now review the role of the Bank of England as prudential supervisor of the banking institutions.** We expect to comment on this further when we report on the collapse of Barings Bank. In the course of their review the Treasury should take further account of our recommendation, in our Report on the Building Society Sector, that "in the long run, the prudential supervision and regulation of building societies should be absorbed into that of the general banking sector, possibly by the amalgamation of the Building Societies Commission with the Supervision Division of the Bank of England."[148] Developments since the latter Report was published - towards a greater liberalisation of building society activities and the coalescence of banks and building societies - has reinforced the strength of the argument in favour of such a development. **A free-standing prudential supervisor of banks and building societies - answerable to and appointed by the Treasury - is a not inconceivable development which has been given greater credibility by the events of the last few years.**

Regulatory arbitrage

111. It is not only self-regulation as practised in its primitive form which offers escape routes for companies wishing to avoid the full impact of the regulatory system envisaged by the Financial Services Act. The ability of companies effectively to choose their own regulator — and thereby to choose the least harsh or disadvantageous regime — is at present written into the legislation. The SIB, fully supported by the SRO's, has made clear its wish to be divested of the responsibility or opportunity for direct regulation of companies who choose not to become members of the appropriate SRO. We are in complete agreement with the SIB on this point, and **recommend that appropriate legislation should be introduced as soon as possible to abolish the right of direct regulation by the SIB (known as SIBRO).** The abolition of SIBRO would have the added advantages of clarifying the respective roles of SIB and the SRO's and of eliminating wholly unnecessary duplication of staff effort and expertise.

Ministerial responsibility

112. A recurring theme during our inquiry has been the need for greater coordination between supervisory and regulatory bodies in order to overcome confusion of responsibilities between different regulators in both vertical and horizontal terms, and to ensure that the regulatory system as a whole is capable of reacting positively to changes in market practices not envisaged when the relevant legislation was written. It would, of course, be possible to attempt to redraw the structure to meet the present profiles of the industries concerned; but this is a dynamic area, where changes must be expected to continue. The Financial Services Act itself has been shown to be reasonably flexible in application, and that flexibility needs to be retained, and to be reflected in the statutory provisions and administrative structures available into the next century.

113. Some clarification of responsibilities by statutory means may be needed. But **it is, in our view, more important that there should be a single authority ultimately capable of knocking heads together and enforcing cooperation between regulators, whatever the specific provisions of the legislation in force at any particular time.**

114. The transfer of the bulk of ministerial responsibilities under the Financial Services Act to the Treasury in June 1992 went some way towards meeting this objective: but it did not go far enough. So long as some responsibilities - for much of the insurance industry, for instance - are located elsewhere it will be difficult or impossible for one Government Department to act both as coordinator of regulatory activities within the United Kingdom, and as the single representative of the United Kingdom in European Union and other international fora. It will also be difficult to ensure that one body accepts the obligation to take an overall view of the development of the regulatory and supervisory system across industrial boundaries.

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[148] Second Report, Session 1994-95 (HC26), para.46.

115. Despite the doctrine that the Government always speaks with one voice on such matters, our evidence has illuminated a real difference of interests between the Departments concerned — the Treasury and the DTI — which, unless resolved, must create a continuing obstacle to a coherent approach to the coordination of policy and action in the field of financial services regulation. In their evidence to us in June 1995, HM Treasury stressed that the Fundamental Expenditure Review of their Department

> "saw considerable logic ... in the eventual transfer to the Treasury of responsibility for all aspects of financial regulation legislation and policy, including prudential regulation of insurance and occupational pensions regulation. Such a move would bring responsibility for overseeing the regulation of all the key financial institutions and markets into one government department; and thereby facilitate a more comprehensive consideration of financial regulation."[149]

116. In the same spirit, we recommended in May of this year the creation of an independent regulatory body for Lloyd's of London, which would be answerable directly to HM Treasury. As a result of the present bifurcation of ministerial responsibility, the Government response to our Report on Lloyd's came from the DTI, and not from HM Treasury. The DTI response chose completely to ignore our proposal that ministerial responsibility should move to the Treasury, and went to great pains to defend the DTI's own role[150] and we can only conclude that they had either failed to consult the Treasury on this issue, or that they had deliberately set aside the strong arguments, deployed by the Treasury themselves, for the concentration of ministerial responsibility for *all* aspects of financial services supervision and regulation in one Government department.

117. It is simply not satisfactory for the DTI to seek to hang on to some ministerial responsibilities in order to buttress its own *amour propre*. The transfer of the bulk of the responsibilities for financial services regulation has clearly been successful; although many of the same personnel have been involved, the transfer has resulted in a much higher Government profile in the regulatory industry and — as Mr Whiting's evidence demonstrated — a more global (as opposed to sectional) approach to the continuing problems confronting the regulators. The DTI's record, at least so far as the Lloyd's insurance market is concerned, has, however, been inadequate and their response to the concerns highlighted in our Report on Lloyd's has shown a remarkable degree of complacency.

118. We accordingly have no hesitation in supporting the views expressed in the Treasury's FER. Irrespective of any immediate change in the Government's attitude towards the reform of the regulatory regime at Lloyd's, **we recommend that ministerial responsibility for all remaining aspects of financial regulation and supervision, including the supervision of Lloyd's of London and the prudential regulation of all other aspects of insurance and occupational pensions, should be transferred to HM Treasury at the earliest opportunity.**

119. The intention of the above recommendation is not merely to ensure neatness and easier comprehensibility for observers of the regulatory system: it is, rather, to ensure that the Treasury should fully accept its own responsibility to coordinate the entire range of regulatory and supervisory activities in the financial services industries, and that Treasury Ministers cannot in future evade responsibility not only for answering questions in this area but also for the creative or (to use the current jargon) "pro-active" role which will be required to adapt the regulatory and supervisory structures to meet the changing nature of the industries and the changing requirements of European Union legislation and other international environments (including, in particular, G7 and the Basle Conventions). **Our recommendation is therefore aimed at encouraging HM Treasury to adopt a more interventionist and active role in the coordination of financial services supervision and regulation.**

120. If such an active coordinating role can be established for the Treasury, there is a greater prospect that the demarcation or "interface" problems confronting the industries and

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[149] Evidence, p.228 (26 June 1995).

[150] Fifth Special Report, Session 1994-95, Appendix paras.I.5-I.8.

their regulators can be resolved by agreement and without recourse to legislation. A more active Treasury role would also enable structural problems to be addressed in a pragmatic fashion: "fundamental" arguments about the relative roles of the SIB and the SRO's could, for instance, be resolved by administrative rather than legislative means. If, for instance, it were eventually to be concluded that the PIA should emerge as a free-standing designated agency alongside the SIB (thus implying separate structures for the retail and wholesale industries), this would be a reasonably manageable change within an overall structure in which the across-the-board coordinating role of the Treasury was acknowledged.

121. The conclusions and recommendations set out above are intended to encourage the continuing evolution of the structure of regulation and supervision in the UK's financial services industries. We expect the Committee to maintain a continuing oversight of the framework as it evolves.

MINUTES OF PROCEEDINGS OF THE COMMITTEE RELATING TO THE REPORT

WEDNESDAY 18 OCTOBER 1995

Members present:

Sir Thomas Arnold, in the Chair

Ms Diane Abbott	Mr Nigel Forman
Mr Malcolm Bruce	Mr Barry Legg
Mr Nicholas Budgen	Mr Mike O'Brien
Mr Matthew Carrington	Mr Giles Radice
Mr Quentin Davies	

The Committee deliberated.

Draft Report (The Regulation of Financial Services in the UK) proposed by the Chairman, brought up and read.

Question proposed, That the draft Report be read a second time, paragraph by paragraph:- Debate arising;

Ordered, That the debate be now adjourned. — *(The Chairman.)*

Debate to be resumed on Monday 23 October at Four o'clock.

[Adjourned till Monday 23 October at Four o'clock.

MONDAY 23 OCTOBER 1995

Members present:

Sir Thomas Arnold, in the Chair

Ms Diane Abbott	Mr Mike O'Brien
Mr Nicholas Budgen	Mr Giles Radice
Mr Matthew Carrington	Mr Brian Sedgemore
Mr Quentin Davies	
Mr Barry Legg	

The Committee deliberated.

Question again proposed, That the draft Report (The Regulation of Financial Services in the UK), proposed by the Chairman, be read a second time, paragraph by paragraph:- Debate resumed.

Question put and agreed to.

Paragraph 1 read and agreed to.

Paragraph 2 read, amended and agreed to.

Paragraphs 3 to 8 read and agreed to.

Paragraph 9 read, as follows:

"9. In our Report on the Retail Sector in 1994, we said:

"Much has been achieved since the 1986 Act came into effect. Although many weaknesses remain, it is incumbent on legislators, as on the regulators and the industry, to promote changes which will contribute to the progressive strengthening of investor protection and to the strengthening of public confidence in the industry. Radical or sudden reform of the system, although intellectually attractive, may well not serve these objectives."

We have heard little since then to persuade us otherwise."

Paragraph disagreed to.

Paragraphs 10 to 21 (now paragraphs 9 to 20) read and agreed to.

Paragraph 22 (now paragraph 21) read, amended and agreed to.

Paragraphs 23 to 42 (now paragraphs 22 to 41) read and agreed to.

Paragraphs 43 (now paragraph 42) read, amended and agreed to.

Paragraphs 44 to 51 (now paragraphs 43 to 50) read and agreed to.

Paragraphs 52 (now paragraph 51) read, amended and agreed to.

Paragraphs 53 to 56 (now paragraphs 52 to 55) read and agreed to.

Paragraph 57 (now paragraph 56) read, amended and agreed to.

Paragraph 58 (now paragraph 57) read and agreed to.

Paragraphs 59 and 60 (now paragraphs 58 and 59) read, amended and agreed to.

Paragraphs 61 to 68 (now paragraphs 60 to 67) read and agreed to.

Consideration of paragraph 69 postponed.

Paragraph 70 (now paragraph 69) read, amended and agreed to.

Paragraph 71 (now paragraph 70) read and agreed to.

Paragraph 72 (now paragraph 71) read, amended and agreed to.

Paragraph 73 (now paragraph 72) read and agreed to.

Paragraph 74 (now paragraph 73) read, amended and agreed to.

Paragraphs 75 to 80 (now paragraphs 74 to 79) read and agreed to.

Paragraphs 81 and 82 (now paragraphs 80 and 81) read, amended and agreed to.

Paragraphs 83 to 86 (now paragraphs 82 to 85) read and agreed to.

Paragraph 87 (now paragraph 86) read, amended and agreed to.

Paragraphs 88 to 93 (now paragraphs 87 to 92) read and agreed to.

Several paragraphs brought up and read, as follows:

"93A. It is clear that current tensions within the regulatory structure - particularly the role of SIB — need to be resolved. The solution depends upon the view taken as to the depth and cause of the problems. In any event it is clear that in fighting amongst the regulators and the jostling for position in any potential new structure is not helping to enhance the public perception of the regulatory system nor adding anything to the achievement of investor protection. The Committee believes that in order to resolve the problems highlighted above the slow evolutionary changes seen in the system so for need to be accelerated and the structure of the Financial Services Act altered in such a way that the regulators charged with the task of ensuring appropriate investor protection are better able to achieve their objectives.

93B. As the system of regulation has moved away from the principle of self-regulation the nature and responsibilities of the SROs have also changed. The Committee recommends that the ultimate objective should be for the SROs to be folded into SIB to become serving departments. There would be two departments; a retail and a wholesale department. Professional involvement will still be guaranteed and unnecessary duplication can be eliminated. Financial institutions and Independent Financial Advisers seeking authorisation will apply in the first instance to SIB which will then decide how a firm's business will be regulated.

93C. There are many advantages that such a new system would confer on the regulation of financial services. Most importantly customers, investors, institutions and foreign supervisors would have a clear, immediate point of contact for all matters relating to financial services. A tier of the existing structure would be removed, reducing costs and inefficiencies. Furthermore SIB would have, and be seen to have, key responsibilities for regulating the industry which would increase its incentive to ensure rapid investigations into any problems that could arise. We also recommend that SIB's powers of detection, investigation and prosecution should be enhanced to ensure that it had the appropriate teeth to back up its bark.

93D. It is only in this way and under such a structure that the circle can be squared; the current difficulties (the lack of public confidence, regulatory creep, tensions between regulators, confused responsibilities, poor communications with foreign supervisors) will be tackled while setting out a blueprint for effective regulation and supervision of financial conglomerates and the products and markets of tomorrow."

Motion made, and Question put, That the paragraphs be read a second time — *(Mr Mike O'Brien.)*

The Committee divided.

Ayes, 3	Noes, 3
Mr Mike O'Brien	Mr Matthew Carrington
Mr Giles Radice	Mr Quentin Davies
Mr Brian Sedgemore	Mr Barry Legg

Whereupon the Chairman declared himself with the Noes.

Paragraph 94 (now paragraph 93) read, amended and agreed to.

Paragraphs 95 to 98 (now paragraphs 94 to 97) read and agreed to.

Paragraph 99 (now paragraph 98) read, amended and agreed to.

Paragraph 100 read, as follows:

"100. That said, we share the Treasury's view that there would have to be overwhelming reasons before the underlying principles of the current system are tampered with. This is a responsible approach, not a complacent one. We have referred during this Report to the possible need for a more fundamental review of the Financial Services Act and other legislation. That may prove to be necessary in the long run; but the Financial Services Act is relatively new legislation, and has been demonstrably flexible in application. Although some legislative amendments are now required, a complete overhaul of the legislative structure for the regulation of the financial services industries would, in our view, be premature and could, at this stage, be destabilising."

Paragraph disagreed to.

Paragraph 101 (now paragraph 99) read and agreed to.

Paragraph 102 read, as follows:

"102.This is a very welcome approach from the Chairman of the foremost regulatory body in the non-banking sector, and it is to be hoped that it will be welcomed by the other regulators as an opportunity to seek collective solutions to the outstanding problems of the industry. It is in principle, in our view, preferable to the implementation of an ex cathedra review on a structure which has to date shown itself captable of developing and adapting without unecessary interference from either Government or Parliament. In a year's time it may be easier for us, and for the Government, to assess whether this approach has yielded sufficient fruit, palatable to all, which would obviate the need for any wider, and externally-imposed, review."

Amendment proposed, in line 4, to leave out from the word "industry." to the end of the paragraph, and insert the words:

"Nor is it inconsistent with our recommendation (in paragraph 93B above) that the existing SROs should ultimately be combined and absorbed within the SIB as the latter's main operating departments. If, as we very much hope, this recommendation is accepted by Government as the ultimate objective, it would be entirely proper for the SIB and the SROs to work together to determine an appropriate structure which would achieve that objective while seeking to preserve the best features of the present arrangements (including substantial practitioner involvement) and maximising the efficiency gains which would flow from greater integration of the two tiers." — *(Mr Mike O'Brien.)*

Question, That the Amendment be made, put and negatived.

An Amendment made.

Paragraph, as amended, agreed to (as paragraph 100).

Paragraphs 103 to 108 (now paragraphs 101 to 106) read and agreed to.

Paragraph 109 read.

Amendment proposed, in line 14, to leave out the last sentence and insert the words "We now take the view that this new body should be directly answerable to the SIB." — *(Mr Quentin Davies.)*

Question, That the Amendment be made, put and negatived.

Paragraph agreed to (as paragraph 107).

Paragraphs 110 and 111 (now paragraphs 108 and 109) read and agreed to.

Paragraph 112 (now paragraph 110) read, amended and agreed to.

Paragraphs 113 and 114 (now paragraphs 111 and 112) read and agreed to.

Paragraph 115 read, as follows:

"115. Some clarification of responsibilities by statutory means may be needed. But it is, in our view, more important that there should be a single authority ultimately capable of knocking heads together and enforcing cooperation between regulators, whatever the specific provisions of the legislation in force at any particular time."

Amendment proposed, in line 1, to leave out the words "may be needed. But it is, in our view, more", and insert the words "will be needed fully to implement our earlier recommendation for the closer integration of the SIB and the SROs. It is in any case" *(Mr Mike O'Brien.)*

Question, That the Amendment be made, put and negatived.

Paragraph agreed to (as paragraph 113).

Paragraphs 116 to 118 (now paragraphs 114 to 116) read and agreed to.

Paragraph 119 (now paragraph 117) read, amended and agreed to.

Paragraphs 120 to 122 (now paragraphs 118 to 120) read and agreed to.

Paragraph 123 (now paragraph 121) read, amended and agreed to.

Postponed paragraph 69 read, amended and agreed to (as paragraph 68).

Question put, That the Report, as amended, be the Sixth Report of the Committee to the House.

The Committee divided.

Ayes, 6	Noes, 0
Mr Nicholas Budgen	
Mr Matthew Carrington	
Mr Quentin Davies	
Mr Barry Legg	
Mr Giles Radice	
Mr Brian Sedgemore	

Resolved, accordingly, That the Report, as amended, be the Sixth Report of the Committee to the House.

Ordered, That the Chairman do make the Report to the House.

Ordered, That the provisions of Standing Order No. 116 (Select Committees (reports)) be applied to the Report. — *(The Chairman.)*

Several papers were ordered to be appended to the Minutes of Evidence.

Ordered, That the Appendices to the Minutes of Evidence taken before the Committee be reported to the House. — *(The Chairman.)*

[The Committee adjourned.

LIST OF ABBREVIATIONS

BBA	—	British Bankers' Association
BBS	—	Board of Banking Supervision
DPG	—	Derivatives Product Group
DTI	—	The Department of Trade and Industry
FIMBRA	—	The Financial Intermediaries, Managers and Brokers Regulatory Association
FOA	—	Futures and Options Association
FSA	—	Financial Services Act 1986
G30	—	Group of Thirty
GAO	—	General Accounting Office
HIP	—	Home Income Plan
HMT	—	Her Majesty's Treasury
ICAEW	-	Institute of Chartered Accountants of England and Wales
ICS	—	Investors Compensation Scheme
IMRO	—	Investment Management Regulatory Organisation
ISDA	—	International Swaps and Derivatives Association
LAUTRO	—	Life Assurance and Unit Trust Regulatory Organisation
LIBA	—	London Investment Banking Association
LIFFE	—	London International Financial Futures and Options Exchange
LSE	—	London Stock Exchange
PIA	—	Personal Investment Authority
RIE	—	Recognised Investment Exchange
RPB	—	Recognised Professional Body
SEC	—	Securities and Exchange Commission
SFO	—	Serious Fraud Office
SFA	—	Securities and Futures Authority
SIB	—	Securities and Investments Board
SORP	—	Statement of Recommended Accounting Practice
SRO	—	Self-Regulating Organisation

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[HC (1994-95) 346-i and ii]

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LIST OF APPENDICES TO THE MINUTES OF EVIDENCE

VOLUME III

LIST OF MEMORANDA REPORTED TO THE HOUSE BUT NOT PRINTED

Copies of the Memoranda listed below are deposited in the Library of the House and the Record Office of the House of Lords. Requests for inspection by the public should be addressed to the Record Office, House of Lords, London SW1 (tel. 0171-219 3074). Hours of inspection are from 9.30 am to 5.00 pm on Mondays to Fridays.

1. Memorandum from the Law Society.
2. Memorandum from Professor David Llewellyn.
3. Memorandum from Professor Brian Tew, OBE, Specialist Adviser to the Committee.
4. Letter from Planned Pensions Ltd.
5. Letter and enclosure from Mr Richard Alexander MP.
6. Letter from Mr Toby Micklethwait.
7. Memorandum from City Finance International Ltd.
8. Letter from Mr A B Craven, Home Income Plan Support Group.
9. Letter from Mr Roy Watson.
10. Memorandum from Mr Kenneth Jordan.
11. Memorandum from the Centre for Service Management Studies.
12. Letter from Mr P G Cheal, Home Income Plan Support Group.
13. Memorandum from Mr Michael Moyse.
14. Letter from British Merchant Banking and Securities Houses Association.
15. Memorandum from Professor Glen Morgan, University of Manchester Business School.
16. Letter from Mr J G Allison.
17. Letter from Mr P J Tyldesley.
18. Letter from Aroused Management.
19. Letter from Mr A N Martin.
20. Letter from Mr J Chaytor.
21. Memorandum from Mr L Bilton.
22. Memorandum from Knight Williams.
23. Memorandum from Dr M J B Hall.
24. Memorandum from Securities and Investments Board (SIB).
25. Memorandum from Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA).
26. Letter from Isthmus Ltd.
27. Memorandum from Butte Mining plc.
28. Letter from Barnett Sampson, Solicitors.
29. Letter from Securities and Investments Board (SIB).
30. Letter from Minister of State, HM Treasury.
31. Letter from Mr P G Cheal, Home Income Plan Support Group.
32. Memorandum from J Keith Park & Co., Solicitors.
33. Further Memorandum from J Keith Park & Co., Solicitors.
34. Memorandum from Mr Michael Moyse.
35. Memorandum from Barnett Sampson, Solicitors.
36. Letter from Carter Action Group, Home Income Plans.
37. Letters from Mr P G Cheal, Home Income Plan Support Group.
38. Letter from the Securities and Investments Board (SIB).
39. Letter from Touche Ross, Management Consultants.
40. Memorandum from the Bank of England.
41. Letter from Mr Peter Bromage, Eversheds, Wells & Hind, Solicitors.
42. Letter from the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA)
43. Policy Statement from Investment Management Regulatory Organisation (IMRO) and Personal Investment Authority (PIA).
44. Letter from the Clerk of the Committee to the Chairman of the Financial Intermediaries, Managers and Brokers Regulatory Association (FIMBRA).
45. Memorandum from the Building Societies Commission.
46. Letter from British Bankers' Association.
47. Papers from Mr Taylor of Barings.
48. Letter from the Governor of the Bank of England.
49. Press Release from Securities and Investments Board (SIB).
50. Letter from Lloyd's Names Defence Association.
51. Speech by Chairman of Securities and Investments Board (SIB).
52. Letter from Lloyd's Names Associations' Working Party.
53. Memorandum from Professor Brian Tew, OBE, Specialist Adviser to the Committee.
54. Letter from Parliamentary Under-Secretary of State for Corporate and Consumer Affairs.
55. Letter from Mr D M Green.

56. Letter from the Minister of State, HM Treasury.
57. Speech by The Hon Christopher Sharples, Chairman of the Securities and Futures Authority (SFA).
58. Memorandum from the Investment Management Regulatory Organisation (IMRO).
59. Memorandum from Life Insurance Association.

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