

Martin

MEMORANDUM

March 29, 1985

TO: Chairman Shad
FROM: Dan Goelzer *Dan*
SUBJECT: Summary of U.K. "White Paper" on Reform of Financial Services

Summary. This "White Paper" outlines the U.K. Government's legislative proposal for an entirely new system of regulation of the financial services industry, to be introduced in the 1985-86 Parliamentary Session. In one sentence, the regulatory framework can be described as follows: "It will be an offence for any 'investment business' to be carried on without authorisation, and only those judged 'fit and proper' to carry on investment business will be so authorised." The Secretary of State for Trade and Industry enforces the "fit and proper" standards, but may delegate this responsibility whenever possible to self-regulatory organizations (SROs) which meet specified criteria.

I. A New Institutional Structure

The proposal would establish two new institutions to regulate most aspects of secondary market activity:

- Securities and Investments Board — an agency created by the Secretary of State to regulate the "investment business," directly and by delegation to private SROs. The Board would be similar to U.S. regulation of brokers, dealers, underwriters and investment advisers under the Securities Exchange Act and the Investment Advisers Act, and would extend as well to their counterparts in the commodities markets.

- Marketing of Investments Board -- similar to the Securities and Investments Board, but created to regulate the marketing of "pre-packaged" investments. It would be similar to U.S. regulation of sales to investors of insurance products, investment contracts, unit investment trusts and shares of open-end investment companies under state insurance law, the Securities Act and the Investment Company Act.

Board members will be appointed by the Secretary of State and the Governor of the Bank of England, in consultation with industry groups. The Boards' rules would have the force of law, and would not be independently reviewable by the Secretary of State prior to their effectiveness. Authorization and disciplinary decisions of the Boards may be referred to an independent tribunal appointed by the Secretary of State, which will have complete, exclusive and final review of the Boards' decisions.

II. The Regulatory Scheme

The proposal would consolidate and slightly modify the requirements for disclosures in offering documents. */ The secondary market, however, is the main focus of reform.

Authorization. Authorization, which is similar to registration in the U.S., is the central concept of the system. Under the new law, it would be illegal to carry on an "investment business" without authorization.

*/ The proposal would gather the scattered provisions governing the preparation of offering documents and permit the Secretary of State to require offering information by regulation. The following would be exempt from prospectus law: offers made to professional (accredited) investors, offers of United Housing Foundation v. Forman type of stock, and sale of assets of a business as a single entity. The Government envisions having different disclosure requirements for unit trusts (including investment companies), and offers to less than 40 persons, or exclusively to foreigners, or exclusively by a company to its employees.

The Secretary of State will have the power to grant or deny authorization. This power can be delegated to the Boards, if they adopt certain required rules and procedures. These Boards may further delegate the power to authorize an "investment business" to private SROs, provided those organizations regulate the admission and conduct of their members and maintain conduct-of-business standards equivalent to Board rules and standards. */

Investment Business. Anyone engaging in an "investment business" must be authorized to do so. **/ "Investment business" would include activities by underwriters, broker-dealers, investment companies, investment advisers, insurance brokers and others. The term is intended to encompass most of the secondary market involving participants acting on behalf of others, and thus excludes transactions by issuers or those purchasing for their own account. It also does not include those who prepare analytical information without giving advice, bona fide newspapers, bona fide investment clubs or employees' "share shops." It does include activities of open-end investment companies, but apparently does not include activities of closed-end investment companies. Finally, regulation of "investment business" is not intended to involve the

*/ The proposal envisions currently-existing private groups as potentially eligible SROs, such as the [London] Stock Exchange, the National Association of Security Dealers and Investment Managers, the Insurance Brokers Registration Council, or the Association of Futures Brokers and Dealers.

**/ An "investment" includes, in addition to most items which may be considered securities under U.S. law, certificates of deposit, nationalized industry stock, financial and commodity futures and options contracts, and life insurance contracts.

Secretary, Boards, or SROs in substantive regulation of banking, insurance or insolvency practice.

III. Standards of Business Practice

The "Fit and Proper" Standard. No investment business can be authorized unless the practitioner is found "fit and proper" by a Board or an SRO. On the basis of required disclosure by the applicant about its business (a "business plan," which apparently does not explicitly require inclusion of financial statements), and about its directors, employees, and control and associated persons, the Board or SRO must make its "fit and proper" determination based on considerations of "probity, competence [and] adequacy of financial resources."

Conduct-of-Business Rules. In furtherance of this general "fit and proper" standard, the Boards and authorized SROs are required to adopt conduct-of-business rules, which apply to all investment businesses authorized by that Board or SRO. These required rules would govern: "best execution" and "subordination of interest" requirements, protection of client assets, compensation for investor losses (whether through industry self-insurance or outside insurance), adequacy and suitability of recommendations, disclosure of business terms such as commissions and fees, the keeping of proper records, procedures for maintenance of orderly markets, and standards for advertisements or circulars which are intended to lead to the purchase of any investment. The legislation also requires special rules in marketing life insurance and "unit trust" investments (including investment companies) and pension management.

Competition. Each rule adopted by a Board or SRO must subsequently be reviewed by the Director General of Fair Trading, a government official. Based on the Director's advice, the Secretary of State may direct withdrawal of a rule "that is detrimental to competition and not justified in the interests of investor protection." The Boards and SROs will be exempt from other U.K. antitrust laws.

IV. Enforcement

The Boards and SROs will be required to periodically inspect the operations, books and records of authorized investment businesses, and will have the power to require production of information. The Boards can impose broad restrictions on authorized investment business, and can ultimately withdraw authorization if necessary. The legislation makes voidable all contracts with a person conducting an unauthorized investment business, and provides a private right of action for violation of the standards of business practice discussed above. The government, in addition to its criminal authority, would be empowered to bring injunction and disgorgement proceedings, and this authority could be delegated to the Boards. The government would have primary responsibility for prosecuting unauthorized conduct of an investment business.

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