Speech by W B Willott to Summer conference of

National Security Traders Association

The mid-1980's have been an eventful period for the UK industry.

In October 1986 we had Big Bang. This had two elements;

First, the removal of fixed commissions on the London Stock Exchange led to the decision to end the single capacity division between jobbers and brokers. This in turn led to major restructuring of the industry as brokers and jobbers were absorbed into wider groupings, with greater financial resources to face the challenge of the US and Japanese groups, who had established themselves also in the London markets.

Second, advances in technology led to the abandonment of floor trading and its replacement by new systems for automatic quotation display and new systems for reporting trades (though not yet for settlement). The Stock Exchange is planning a new system for automatic execution of small orders to be introduced shortly. That is to be followed within a year or so by a system, familiar to you in the United States, of electronic settlement of transactions within a depositary system, though this will require legislation to enable it to be implemented.

At the same time, a new system of regulation has been put into place. This originated from certain notorious cases in the early 1980s where the existing system of investor protection proved inadequate. Following Professor Cower's Report, which recommended a new system of

regulation the Government published a White Paper in 1985 setting out its proposals. These finally emerged as the Financial Services Act 1986 which came into force on April 29th this year. One important ingredient in the new policy was the need to provide new arrangements to replace the safeguards that had previously been in place with the historical separation of the functions of brokers and jobbers.

As so often happens, this new structure grew more and more complex as it was developed. Although it started from the need to provide protection for Aunt Agatha it also had as an objective to assure the integrity and liquidity of professional and retail markets. Indeed the growing sophistication of financial products, the interconnections between markets and the uncertainty about future trends in the marketplace made a strong case for avoiding artificial, regulatory-induced barriers between different markets. So as the rules were developed by the practitioner based regulatory bodies, the concept of the "level playing field" became a significant element.

In its basic structure, the Financial Services Act follows well established principles which will be familiar to an American audience. First, there is a requirement that any-one carrying on investment business in the UK must be authorised to do so. Failure to meet this requirement is a criminal offence. The definition of investment business is one which involved an enourmous amount of discussion. It covers stocks, bonds and debentures, futures and options, long term insurance contracts and collective investments such as unit trusts, mortgage bonds etc. Trading in the money markets, or in currency, (the wholesale money markets) is regulated by the Bank of England. To allow for future market developments we have the power to change the

definitions without the primary legislation; this power has already been used to fine tune the definitions of investment business covered or not covered by the Act.

Authorisation is granted if a firm is able to demonstrate that it is "fit and proper" to carry on such business – that in turn effectively means that it should be honest, competent and financially secure.

The second protection is the requirement that authorised firms should comply with a set of rules regulating the conduct of their business. These rules developed in accordance with basic principles set out in the Act cover all the major areas such as due care, best execution, separation of client funds, maintenance of proper records, knowing your customer, and disclosure. The rule book as a whole is backed up by a wide range of civil and intervention powers.

Finally, because of the importance of financial stability in the financial markets we have been developing in the UK sophisticated capital adequacy rules which are designed to give proper protection without obliging firms to tie up unnecessarily large amount of capital.

Where the UK system is perhaps unusual, however, is the balance we have endeavoured to strike between a statutory system with the back up of the law and the best features - in particular flexibility, adaptability and commitment of the participants - of the old self regulatory systems. At the centre of the new system is the Securities and Investments Board, a constitutional novelty consisting to a considerable extent of practitioners and users of the markets, but operating under powers provided by Parliament and transferred to it by the Secretary of State. Through its rule

book and its power to recognise other bodies for the purposes of the Act it sets the standards for authorisation and regulation throughout the new system. It also has the responsibility, shared with the Department of Trade and Industry in a number of areas, for using the Act's sanctions, both criminal and civil. It also has the responsibility for regulating those firms which choose to seek direct authorisation from the SIB rather than to join a self-regulatory organisation (SRO). However, it is this second tier, of SROs, which will be responsible for regulating the bulk of authorised firms. It is the membership requirements and the rule books of these SROs, enforced by contract, which will regulate the business of most firms. Nevertheless, the Act does provide for SIB (or where appropriate the DTI) to stand behind the SROs by existing statutory powers where necessary.

London is, of course, an international centre and many overseas companies carry out business there. We believe it is important that the regulatory regime should provide a fair but effective mechanism for regulating overseas companies operating in the UK. The need is to provide a satisfactory level of investor protection, to protect against the impact on UK markets of financial failures elsewhere, whilst minimising the extent of dual or overlapping regulation. Companies may conduct their business in the UK in three main ways:

a) by a UK incorporated subsidiary. In this case it will be treated exactly like any other UK firm.

b) by establishing a 'branch'. In this case it will be the parent legal entity which must be regulated, although authorisation to carry on such business in the firms'

home country will obviously be taken into account.

c) by operating on a “services” basis from a place of business outside the UK. The Act has a special regime for certain European Community firms operating on this basis.

In the case of overseas companies operating on a branch or services basis the rules may need to be modified. It is recognised that there may be practical problems in applying UK capital adequacy rules to branches and their overseas parents bearing in mind that their balance sheets may relate largely to non-UK activities. The SIB and the SRO’s are therefore developing arrangements whereby the UK capital requirements may be disapplied where there is adequate supervision by the home regulators and those regulators are able and willing to co-operate with the SIB or SROs in monitoring the firm. The SIB are currently negotiating arrangements of this nature round the world.

There have been numerous complaints that the Financial Services Act imposes unnecessary costs and burdens on the industry. There is bound to be criticism when a new system is introduced. Any change involves transitional costs at the very least and new systems may need adjustment in the light of experience. We have been careful to make the system flexible so that changes can be made. We are looking at what changes are needed now. The regulatory structure is practitioner-

based, and we believe that the practitioners in their SIB and the SRO's are best placed to judge how regulation can be made cost-effective.

It is very important, therefore, for individual firms to make their views known, to SIB or to their SROs, on how the rules can and should be improved. I hope that those of you who participate in the London markets will contribute actively and offer constructive suggestions.

The Financial Services Act also provides for the recognition of Stock Exchanges and Clearing Houses. Their rules have to meet certain requirements laid down in the Act before they can be recognised by the SIB. All the major exchanges were recognised by the SIB before the Act came fully into force on 29 April.

There are special provisions to enable Overseas Exchanges and Clearing Houses to conduct their business in the UK. Many exchanges around the world are still floor-based, and to that extent geographically constrained, but the regulatory regime also needs to provide an equitable - and in competition terms, a neutral - regime for electronic, non-floor based systems. I have to say that I believe we are at the frontier of regulation in this area. At the present time we have two mechanisms by which exchanges can be enabled to carry out business in the UK;

a) Authorisation by the SIB, which means that the arrangements are adequate to protect UK investors;

b) Recognition by the DTI, in which case we have to satisfy ourselves as to the adequacy of the home regulation and we need arrangements with the home regulator to ensure adequate exchange of information.

Under the Second option NASDAQ of the USA became a recognised investment exchange on 2 April so that market makers or brokers in the UK can do deals with each other or with US counterparts on the NASDAQ system if the Atlantic did not exist.

Looking into the future it seems likely that more exchanges will seek to expand their business through increased use of computers and telecommunications, either alone or in links with other exchanges. This should, if handled properly, increase competition and improve choice and quality of service available to users of the markets. The international regulation of a series of overlapping electronic networks will need to be carefully handled if the twin risks of costly overlapping regulation or ineffective regulation are to be avoided.

This brings me to my second main theme today, of international collaboration between regulators. International financial trading is of course no novelty but it has in the main been the preserve of banks and professional players. The trend to securitisation, technology, and the wave of liberalisation of the 1980's has thrust the internationalisation of the securities industry forward at a rapid pace. Specific features of the securities industries, such as financial exposure as a result of price variability, and the protections needed for investors, raise complex and novel issues at the international level. Addressing these is not made easier by the rather different structures for the regulation of securities from country to country and the different regimes in each country.

Nevertheless collaboration is on the move, at various levels. For example, the historical links of a general nature between stock exchamges are developing to address such matters as how to permit common offerings. Self-regulating organisations are developing arrangements for exchanging information to enable them to maintain the integrity of their markets. Cooperation is also growing at the level of the atatutory regulators.

Let me take two specific examples where this is important. The Stock Market crash of last October threw up into dramatic relief the extent to which the different markets around the world are not only now moved by common perceptions of economic trends and market sentiment, but are effected by rumours of financial weakness of individual international players. In order to preserve the financial integrity of the major markets round the world there is a clear need for two things: agreement on capital requirements that will provide for reasonable financial stability of market participants, and an effective system for rapid sharing of information between regulators in both normal times and particularly in time of crisis. The approach is likely to mirror that for banking supervision. The work of the Cooke Committee provides a precedent and there will clearly need to be close liason between work on capital requirements for securities business and the banking requirements evolved by the Cooke Committee. On the securities side the institutional arrangements are less well established but IOSCO seems to be developing a useful role in the technical work underpinning international collaboration on this and other fronts.

The second example concerns the detection and successful policing of fraud and insider dealing. Here the critical factor is the ability to exchange information between regulators responsible for such policing. The difficulties in this area arise from the differing juridical systems of the

countries concerned and the - often quite severe - constraints on passing to another authority information about persons within the jurisdiction. To the extent that legal procedures may often be involved questions of extra-territoriality also arise. The solution adopted so far has been the development of a series of informal arrangements or memoranda of understanding bilaterally between regulators providing for mutual assistance and exchange of information. I envisage the number of such agreements growing rapidly in the next year or so. The regulators concerned already meet informally, from time to time, in the Wilton Park group and it is quite possible that as experience of the bilateral arguments develops in may end up with the equivalent of a multilateral arrangement such as exists in other areas of collaboration against international crime.

My third theme today concerns the development of the European Community into a single market in 1992.

Britain has pressed long hard for the creation of a common market in goods and services for which the Treaty of Rome had provided. But with Member States' attention diverted by disputes over agricultural and budgetary matters, such a common market was slow to come.

In 1985, the Commission published a White Paper which set out a programme of some 300 measures to remove the remaining barriers to trade between EC Member States.

This ambitious programme of legislation was endorsed by the Single European Act and the target date of 31 December 1992 has been set for the completion of the single market.

Completing a single market in financial services is a major plank of this programme.

In banking, a second Directive on the co-ordination of credit institutions is currently under discussion. A parallel Directive for securities, the Investment Services Directive, is in the final stages of consideration by the Commission. The aim of both Directives is to establish sufficient harmonisation of authorisation procedures and supervisory standards to allow what the Commission calls "mutual recognition of home country authorisation". The aim is to allow an institution authorised in one Member State to do business throughout the Community - on a branch or services basis - on the basis of authorisation by its home country supervisor.

Insurance is another important area. A non-life insurance services Directive was finally adopted in June. The Directive allows Community insurers to cover large risks in any Member State, irrespective of where the insurer is established. For example, a businessman in France has historically been unable to insure his factory in London or Frankfurt. When the non-life insurance services directive comes into force by 1992, insurers from all round the Community will be able to compete for that business.

The major plank of liberalisation underpinning all these measures in the financial sector is freedom of capital movements. There cannot be a genuinely free market in financial services without this. I am glad to say that the Council of Ministers in June endorsed proposals which, will effectively sweep away all barriers to the free movement of capital between the major EC markets by 1992.