

Financial Services and Markets Act 2000 – I

by Michael Taylor

The author considers the policy background to the Financial Services and Market Act and the regulatory reforms introduced by the new legislation in a two-part article taken from a forthcoming book of which he is co-author.

The *Financial Services and Markets Act* ('the Act') gives legal basis to the radical reform of the UK's system of financial regulation announced by the government soon after the May 1997 general election. The extent of the government's radicalism in reforming financial regulation took many practitioners and commentators by surprise. The Labour policy handbook *New Labour, New Life for Britain* had, perhaps deliberately, been vague about the new government's plans for financial regulation. It promised only to 'reform and strengthen the regulatory system' and 'to simplify both the structure and the nature of the system so that it commands the confidence of both the public and the industry'. While the *Financial Services and Markets Act* is consistent with both these statements, it goes much further than many observers had anticipated.

The obvious respect in which the Act is a radical measure is in providing statutory underpinning for the Financial Services Authority (FSA). This new authority combines the regulation of banking, securities, and insurance business and replaces no fewer than nine pre-existing regulatory bodies. Indeed, the FSA is practically unique among regulatory agencies in the industrialised world in terms of the diversity of businesses regulated, and its very broad scope, encompassing both prudential and business conduct regulation. (Prudential regulation is concerned with the financial soundness of regulated institutions, whereas business conduct regulation is instead concerned with the way in which their products are marketed and sold.) While other integrated financial regulators have been in existence for some years, most notably in the Scandinavian countries, none has been established in a country with a financial sector of the size of that of the UK's, and all have an exclusively prudential focus. It should not be surprising, therefore, that such a radical reform of regulation, especially as it affects one of

the world's leading international financial centres, should have attracted such widespread attention far outside Britain.

A second respect in which the new Act is radical is in the range of enforcement powers it grants to the FSA. These go a significant way beyond the combined powers of the bodies it replaces. Especially significant are the FSA's enforcement powers in respect of its Code of Market Conduct. Under these provisions of the Act the FSA will be able to seek civil remedies, i.e. levy fines, against individuals or firms who breach the Code through insider dealing or attempted market manipulation. It will also be able to apply to the High Court for disgorgement/restitution orders. This aspect of the Act's radicalism had received greater public discussion than the unification of supervision, as speeches by Sir Andrew Large, the former chairman of the Securities and Investments Board, had strongly argued the case for a civil route for the disposal of such cases in parallel to the existing criminal law. Nonetheless, this change represents a substantial departure from past City regulation, while also conferring on the FSA a range of powers that are practically unique among other regulatory bodies in the world.

Although the Act's radicalism is apparent on the surface, in another sense it is also the product of a long process of evolution. Although the government's May 1997 announcement was as sudden as it was unexpected, it nonetheless reflected the UK's experience of financial regulation over a period of many years. Thus, as well as representing a radical departure from past practice, the Act can also be regarded as the outcome of a long process of gradual change in the regulation of Britain's financial sector. The process of regulatory change was itself motivated by, and was at times a catalyst for, more fundamental changes in the structure of the regulated industry. Thus to understand the policy background to the Act it is necessary to understand the processes of both

industry and regulatory change extending back over several decades.

The evolution of the UK's financial sector since the early 1980s can be thought of as the gradual confluence of three previously quite separate streams. These comprised the Bank of England and the 'primary' banking sector; the organised markets in the City like the Stock Exchange and Lloyd's; and the rest of the financial sector, including building societies and insurance companies and licensed securities dealers. Each of these streams exhibited significant differences in the style and nature of regulation, especially in the balance between statutory and self-regulation.

The story since the early 1980s has been one of the gradual erosion and disappearance of the distinctions and boundaries between these different streams. Once distinct financial activities have become more closely integrated, and financial institutions have become active in several of once distinct activities of banking, securities and insurance. Moreover, in parallel to this process, another has been in evidence in which the balance between statutory and self-regulation had shifted decisively in favour of the former in each of the three component parts of the financial sector. This has resulted in a primarily informal and extra-legal system of financial regulation being largely replaced by one largely based on statute. The two processes of regulatory and industry change are closely linked and have exercised a fundamental influence on the need for the type of regulatory consolidation represented by the formation of the FSA.

FINANCIAL REGULATION AT THE TIME OF THE WILSON COMMITTEE

To understand the process described above it is necessary first to give an account of the regulation of Britain's financial sector circa 1978, at the time of enquiry into Britain's financial system chaired by Lord (Harold) Wilson. Ironically, this report described a set of arrangements that even then were on the verge of passing away, but for this reason it is a valuable snapshot of a now vanished world. This description can then serve as the prelude to tracing the subsequent developments that have given rise to the formation of the Financial Services Authority. The emphasis of the pre-1980 period was on the relative absence of statute law from two of the three streams, in contrast to the third stream where statutory regulation played a very significant role from an early stage.

Prior to the passage of the *Banking Act* in 1979, Britain had lacked any system of formal authorisation or supervision of its banking sector, at least since the repeal in 1856 of Peel's 1844 *Banking Act* (7&8 Vict. c 113). (For a history of banking regulation in Britain see Heidi M Schooner and Michael Taylor, 'Competition and Convergence: The case of bank regulation in Britain and

the US', *Michigan Journal of International Law*, Vol 20, No 4, Summer 1999). Although the Bank was empowered, by s. 4(3) of the *Bank of England Act 1946*, to issue directives to the banking sector, this power was never formally invoked. Instead, the Bank of England exercised informal powers of moral suasion over the banking sector, relying largely on its ability to dispense favours (especially access to its lender of last resort facilities) in return for co-operation on the part of the banks with which it dealt. These were principally the clearing banks, discount houses and accepting houses, which together constituted the 'core' or 'primary' banking sector. In addition to its powers of moral suasion the Bank also relied to a substantial extent on the forces of self-regulation, especially that exercised by organised committees of institutions like the Accepting Houses Committee or the London Discount Market Association. The efficacy of this approach to regulation was based to a substantial degree on the relatively small and concentrated nature of the constituency with which the Bank dealt. The widespread acceptance of informal norms of behaviour, including the acceptance of the Bank's unique responsibilities in relation to the rest of the banking sector, also served to ensure that the Bank's writ ran large.

The Bank of England's relationship with the primary banking sector extended far back into the nineteenth century when the Bank evolved from the dominant commercial bank into one discharging many of the functions of a recognisable modern central bank. Informal monitoring of the banking sector was conducted by the Bank's Discount Office which developed a number of characteristics that were later to inform the Bank's approach to statute-based banking supervision: it was informal, flexible, and – unlike the US – based neither on law nor on formal on-site examinations. The cornerstone of the Discount Office's approach to supervision was the interview – as it was to remain for much of the period following the advent of statutory regulation. The Bank regarded this type of regulation as 'non-statutory' rather than 'self-regulatory', since it followed from the 'customary' and 'traditional' role of a central bank in ensuring orderly markets and prudently run banks (see the Bank's submission to the *Committee to Review the Functioning of Financial Institutions, Second Stage Evidence*, Vol. 4 at 96).

The second component of the pre-1980 financial sector comprised the organised markets, including the Stock Exchange, Lloyd's of London and the various commodities exchanges. Like the supervision of the banking sector, the regulation of these markets relied to a substantial degree on informal norms of behaviour rather than on statute law. The Bank of England took a keen interest in the functioning of these markets, albeit relying for its authority on City tradition rather than statute. It would not have been too wide of the mark to describe the Bank's self-appointed role in this period as the City's chief prefect, imposing informal disciplinary norms on the primary

banks and organised markets alike, and representing the City's interests to government. It was in this capacity, for example, that the Bank played the leading role in organising the Council for the Securities Industry (CSI) a short-lived attempt to bring a greater measure of co-ordination to City self-regulation.

Notwithstanding the Bank's 'prefectorial' interest in them, the organised markets were genuinely self-regulatory bodies, displaying many of the characteristics of club-type arrangements, albeit subject to varying degrees of oversight by government departments. As the Stock Exchange explained in its evidence to the Wilson Committee, 'the principal feature of the regulatory system in the UK is that, within the general framework of the law, the authority of the supervising bodies is drawn not from statute but from the consent of the users of the market. It is a system in which the Stock Exchange has throughout played and still fulfils the central role.' (*Committee to Review the Functioning of Financial Institutions, Second Stage Evidence, Vol. 4, at 16.*) Stock Exchange rules were intended to provide protection to users of the market, of which the cornerstones were the companies listing requirements (administered under the *Companies Act*) and the system of single capacity, which prohibited members from acting as both broker and dealer (or 'jobber') in the old Stock Exchange terminology. Fixed commissions were also in theory supposed to provide the investor with a degree of protection.

Similarly, in its evidence to the Wilson Committee, Lloyd's insurance market also outlined a self-regulatory system in which 'the Committee of Lloyd's plays a very considerable part in supervising the operations of Lloyd's Underwriters, subject to the overall control of the Department of Trade. Before admitting a new Underwriting Member, the Committee satisfies itself as to the candidate's integrity and financial standing. Thereafter, the Committee supervises the conduct of the Annual Audit of accounts of every Underwriting Member. This form of self-regulation, which operated at Lloyd's for many years prior to the introduction of statutory requirements, works extremely well.' (*Committee to Review the Functioning of Financial Institutions, Second Stage Evidence, Vol. 2, at 76–77.*) What was true of the Stock Exchange and Lloyd's was also true of other City organised markets, like those for commodities or the fledgling market for financial futures. These organised markets represented City 'self-regulation' in the truest sense of the word, in that the setting of rules for conduct in these markets was left to the determination of self-governing committees of practitioners subject to only the most limited statutory oversight.

The role of statute law was completely different in relation to the third component of the financial system. This comprised a diverse group of institutions that had in common only that they were not subject to the City's self-regulatory traditions, and that their regulation was to a

substantial degree based on statute law. It embraced securities dealers who were not members of the Stock Exchange, the building societies, savings banks, insurance companies, and friendly societies.

The origins of the legislation governing this sector can be traced back into the middle of the nineteenth century, when Victorian social reformers attempted to encourage the habits of thrift among the great majority of the working population by facilitating new forms of saving institution. For example, the first *Building Societies Act* was enacted in 1836, followed by another in 1874. To ensure the security of the modest savings of working people, the legislation resulted in a high degree of regulation. It limited the types of activities in which these institutions could engage, and subjected them to governmental supervision either through a dedicated regulatory commission (the Building Societies Commission or the Friendly Societies Commission) or by the Department of Trade.

SIGNIFICANT POWERS

Especially significant are the FSA's enforcement powers in respect of its Code of Market Conduct. Under these provisions of the Act the FSA will be able to seek civil remedies, i.e. levy fines, against individuals or firms who breach the Code through insider dealing or attempted market manipulation.

In some instances legislation was introduced specifically in response to certain types of financial scandal: this was true of the introduction of legislation on insurance companies which was influenced by a series of Victorian scandals, in particular the failure of the Albert Life Assurance Company in 1869 which gave rise to the *Life Assurance Companies Act* of 1870. A series of scandals also contributed to the regulation of non-Stock Exchange securities dealers following a number of 'share-pushing' incidents in the 1930s. The report of the Commission of Enquiry established to examine the matter, the Bodkin Committee, made recommendations that resulted in the *Prevention of Fraud (Investments) Act* 1939 ('PF(I)'), which was effectively re-enacted in 1958. This required securities dealers who were not members of the Stock Exchange to be licensed by the Department of Trade.

An important feature of the pre-1980 system was that although the UK had never enacted statutory measures analogous to the US Glass-Steagall Act, which separated commercial and investment banking, its financial markets were nonetheless highly fragmented and compartmentalised. Stock Exchange rules effectively prohibited membership by banks, which were therefore prevented from evolving into continental-style universal banks. The activities limitations on building societies prevented them from becoming serious competitors to banks in the provision of consumer and commercial credit or the provision of payments services.

Cross-ownership of banks and insurance companies was discouraged by the Bank of England and the Department of Trade. Furthermore, various customs and practices served to limit competition, ranging from officially sanctioned cartels (like that among dealers in the government bond market) to the convention that banks did not compete with building societies for the latter's core business, mortgages. As a result the three streams of the financial sector remained largely separate and the degree of convergence between them was negligible. Until the end of the 1970s it was still largely possible to regard these three main elements of the financial system as belonging to distinct spheres, with their own traditions and styles of regulation.

THE 1980s AND THE ADVENT OF STATUTORY REGULATION

The pre-1980 system came under pressure from a number of distinct sources which served to undermine it from both within and without. The first such factor, at least in terms of time, was the secondary banking crisis of 1973–75. The so-called 'secondary' banks were, by definition, outside the 'primary' sector which formed the focus of the Bank of England's non-statute based supervision. Instead, they were recognised as banks by virtue of s. 123 of the *Companies Act* 1967, the sole purpose of which was to exempt them from the need to obtain a licence under the *Moneylenders Acts* 1900–1927. It provided for institutions conducting the business of banking to be exempt from the *Moneylenders Acts* on provision of a certificate by the Department of Trade. However, s. 123 certificates gave legitimacy to the formation of a large number of 'secondary' banks, which were not subject to authorisation and supervision by either the Department of Trade or the Bank of England. The existence of this secondary banking sector, combined with loose monetary and fiscal policies in the early 1970s, combined to produce a speculative property bubble. When this burst the secondary banks were left heavily exposed to a property sector that was unable to meet its repayment obligations. A number of institutions faced serious liquidity problems, and as the crisis wore on a growing number of them became insolvent. In response the Bank of England launched the 'lifeboat' a rescue package for troubled secondary banks to which it and the clearing banks committed £1,200 million. (For a detailed account see Margaret Reid, *The Secondary Banking Crisis*, London: Macmillan, 1982.)

The *Banking Act* 1979 was a direct consequence of the secondary banking crisis. Central to the Act was an attempt to preserve the Bank's traditional relationship with the core banking sector while requiring authorisation and supervision of the secondary sector. It thus drew a distinction between 'recognised banks' – the former primary sector – and 'licensed deposit takers' (LDTs). The remaining secondary banks were licensed as deposit takers

and were subject to more intensive supervisory monitoring than were the recognised banks. The distinction was a way of preserving the Bank of England's long-cherished principle of applying a flexible supervisory regime to those institutions with which it historically had enjoyed a close relationship. Although the Bank of England gained responsibility for banking supervision under the new Act, significantly from the point of view of more recent developments, both the then Prime Minister (Lord Callaghan) and Chancellor (Lord Healey) apparently had their reservations about its suitability for the role. (See Michael Moran, *The Politics of Banking: The Strange Case of Competition and Credit Control*, 2nd edn, London: Macmillan, 1986, at 120). Even some within the Bank argued against it taking on this responsibility, and consideration was briefly given to establishing a separate banking commission. Ultimately, however, the traditionalist position that regarded banking supervision as an essential central banking function prevailed.

LONG PROCESS

As well as representing a radical departure from past practice, the Act can also be regarded as the outcome of a long process of gradual change in the regulation of Britain's financial sector.

The 1979 *Banking Act* was replaced in short order by another, the 1987 *Banking Act*. The collapse of Johnson Matthey Bankers (JMB), a recognised bank under the 1979 Act, revealed the deficiencies of the two-tier system, especially the Bank's limited powers to require information of the recognised banks. Thus, the 1987 Act abolished the two-tier banking system and introduced a single banking authorisation based on the concept of an 'authorised institution'. It also granted the Bank significantly more extensive information gathering powers, including the ability to require banks to commission reports from audit firms to verify the information they sent it. Yet despite the extensive powers it was granted under the new Act, the Bank was perceived in some quarters to be struggling with its statutory responsibilities and, as Sir Thomas Bingham noted in his report on the closure of the Bank of Credit and Commerce International (BCCI), on occasion seemed reluctant to use its powers to the full. The Bank's role in both the BCCI episode in 1991 and the collapse of Barings in 1995, attracted widespread public criticism and again raised doubts about whether it was the right body to conduct banking supervision.

The switch from a non-statutory to a statutory system of banking supervision was accompanied by equally fundamental change in the City of London's organised markets, and especially the Stock Exchange itself. A number of factors combined to undermine the City's old-established self-regulatory traditions and to pave the way

for a statute-based system. Among them were the growing internationalisation of the City, as increasing numbers of foreign institutions began to play an active part in its markets, especially after the end of exchange controls in 1979. The telecommunications revolution, which laid the foundation for today's integrated, global financial markets also facilitated this process. The government's privatisation programme, which aimed to create a new class of shareholders who had never before owned shares (the 'Sids' of the famous British Gas advertisement), also meant that changes to the system of investor protection were necessary. As a result, the old systems of City self-regulation, which had relied to a substantial extent on the existence of a network of relationships underpinned by shared norms of behaviour, began to come under increasing strain.

Although each of these factors was a major driver of legislative and structural change in City regulation, there were several other more specific factors that gave rise to the 1980s revolution. The first was the Stock Exchange's Big Bang. This was the result of (Lord) Roy Hattersley's referral of the Stock Exchange's rulebook to the Office of Fair Trading under the *Restrictive Trade Practices Act 1956*. Following the change of government in 1979 the referral was dropped, but subject to an agreement (the 'Parkinson-Goodison agreement') between the then Secretary of State for Trade and Industry and the then Chairman of the Stock Exchange. Under the terms of this agreement, the Exchange agreed to abolish minimum commissions, put an end to single capacity (thus allowing the development of broker-dealers) and permit outside firms to take over member firms (previously outside firms had been limited to a 30 per cent shareholding.) The result of these changes was further to dilute the sense of the Stock Exchange as a club with the ability to enforce its own membership rules. The abolition of single capacity removed what had been seen as one of the bulwarks of investor protection under the old regime.

In parallel to these changes was the review of investor protection conducted by Professor L C B ('Jim') Gower. This was established following a series of financial scandals in the late 1970s and early 1980s, culminating in the collapse of the Department of Trade regulated investment manager Norton Warburg. Gower's remit was almost that of a one-man royal commission, with terms of reference that required him 'to consider the statutory protection required by private and business investors in securities; to consider the need for statutory control of securities dealers, investment consultants and investment managers; and to advise on the need for new legislation'. Gower had long supported the concept of a Securities and Exchange Commission for the UK (at least since his work on an earlier Royal Commission on Company law in 1960), and in his initial discussion document expressed support for it as the ideal. However, he also recognised that it was not practical politics, not least because of the City's 'rooted

opposition to a commission'. He accordingly proposed a system of self-regulating organisations which he believed would fill some of the gaps in the coverage of the old system. Importantly, it involved repeal of the PF(I) and subjecting all securities dealers, whether or not they were members of the Stock Exchange, to the same Securities Act. Under the proposed arrangements the Stock Exchange would become a self-regulating organisation ('SRO') while there would be another SRO dealing with public issues and takeovers. Gower's proposed structure of SROs was completed by one for the over-the-counter market and another for the unit trust industry. The government's role in this system was to be relatively hands-off, limited only to the authorisation and on-going monitoring of the activities of the SROs.

The completion of Gower's report was pre-empted by the government introducing a bill which subsequently became the *Financial Services Act 1986* ('the FS Act'). The FS Act contained a number of significant departures from Gower's original proposals. Although it stopped short of establishing a statutory securities commission, as advocated by the opposition Labour Party, it nonetheless created a new body to oversee the work of the SROs. This body, the Securities and Investments Board, although a private company limited by guarantee, exercised powers transferred to it from the Department of Trade, and had the general responsibility to ensure that the SROs regulated in the public interest. Its first chairman, Sir Kenneth Berrill, argued strongly that, although the new body would not be responsible for the regulation of securities offerings, it would 'to all intents and purposes be exercising the powers of an SEC in this country'. Nonetheless, many commentators continued to compare the powers of the new agency unfavourably with those of the US Securities and Exchange Commission.

SEE CHANGE IN ATTITUDES

While it is possible to criticise the FS Act and its regulatory bodies both for matters of conception and execution (some of these criticisms will be examined later) this should not detract from the fact that the new regime resulted in a substantial sea change in City attitudes towards regulation.

Also significant was the structure of the system of SROs: instead of following the US system, as proposed by Gower, in which the Stock Exchange would have become an SRO, the regulation of brokers and dealers was separated from market regulation, and a new SRO established to regulate these firms. There were also SROs for futures brokers and dealers, for investment managers, and for investment advisers. In addition, whereas Gower's original terms of reference had referred only to securities, the authorisation regime introduced by the new Act also encompassed

complex products like life assurance and personal pensions. Hence the marketing and sales practices governing these products became subject to regulation for the first time, and an SRO was established to regulate the providers of these products. However, despite its otherwise broad coverage, the FS Act did not extend to Lloyd's of London, an omission which also drew criticism from the Labour opposition.

INFLUENCE OF PRIVATISATION

The government's privatisation programme, which aimed to create a new class of shareholders who had never before owned shares (the 'Sids' of the famous British Gas advertisement), also meant that changes to the system of investor protection were necessary. As a result, the old systems of City self-regulation, which had relied to a substantial extent on the existence of a network of relationships underpinned by shared norms of behaviour, began to come under increasing strain.

The need to reassure a sceptical, and sometimes hostile, City community meant that the government stressed the self-regulatory element in the new system (in the words of David Lomax in his early study, *London Capital Markets After the Financial Services Act*, there was 'obsience to the principle of self-regulation'). In fact, however, the FS Act introduced a substantial degree of statutory regulation into the affairs of the City's organised markets for the first time. It also went a substantial distance towards eroding the distinction between the second and third streams of financial sector regulation. In particular, the non-Stock Exchange securities dealers, previously subject to the PF(I), were brought within the same regulatory apparatus as the Stock Exchange's membership. While it is possible to criticise the FS Act and its regulatory bodies both for matters of conception and execution (some of these criticisms will be examined later) this should not detract from the fact that the new regime resulted in a substantial sea change in City attitudes towards regulation. The Financial Services and Markets Act would simply have not been feasible without the groundwork of its predecessor. In this context it is significant that although the Labour Party opposed several aspects of the FS Act, they did nothing to prevent it reaching the statute book.

The third stream of the UK's financial sector also experienced significant legislative change in the 1980s. The most obvious development, as just mentioned, was the replacement of the *Prevention of Fraud (Investments) Act* with the *Financial Services Act*. However, other legislation also powerfully affected this stream. Most notably, the *Building Societies Act 1986* introduced a significant measure of deregulation into this previously highly regulated sector, permitting the societies to compete with joint stock banks in retail financial products, including current accounts. Given that the banks had a few years earlier moved into the

market for mortgages, once the exclusive preserve of the societies, competition between joint stock and mutual institutions was now intense. The privatisation of the Trustee Savings Bank in 1988 also added an extra dimension to competition in high street banking.

Overarching developments in each of these separate sectors was the growing influence of EC law on the pattern of UK financial regulation. The 1979 *Banking Act* had, significantly, been in part necessary to comply with the first Banking Co-ordination Directive. However, as part of the regulatory harmonisation required to complete the European Internal Market in financial services, the late 1980s and early 1990s also saw a series of directives on specific aspects of regulatory policy. A number of these were based on the concept of a 'credit institution', which embraced both banks and building societies, thus laying a common platform for their prudential regulation. Moreover, the banking directives were premised on the continental European model of a universal bank. Thus the Capital Adequacy Directive, which set capital requirements for market risk for both banks and investment firms, raised the issue of how competitive equality between banks and securities firms could be preserved if the same directive was implemented by different sets of regulators.

EC law also resulted in the rules relating to banking regulation becoming more prescriptive than the Bank of England had traditionally favoured, given its preference for a flexible style of regulation. This preference had meant that the Bank had attempted to keep the number of detailed rules with which banks had to comply to the bare minimum, relying instead on the judgment of its individual supervisors. By contrast, the regulators established under the FS Act had formulated extensive rulebooks governing the behaviour of securities firms. The arrival of EC directives that applied to both classes of institution resulted in a growing convergence between the Bank's techniques of regulation and those traditionally practised by the securities regulators.

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