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1. Introduction

In January, 1985, the Government of the United Kingdom published a White Paper [1] setting out its proposals for a new framework for investor protection in the United Kingdom. These proposals were largely based upon an exhaustive analysis by Professor L.C.B. Gower of the present regulatory system and its inadequacies.

In July of 1981, the Secretary of State for Trade commissioned Professor Gower, a research adviser on company law to the Department of Trade and Industry (“DTI”), to undertake a review of investor protection in the United Kingdom. The purposes of this review were threefold: to examine the existing statutory protection required by private and business investors in securities and other properties such as unit trusts and open-ended investment companies [2]; to consider the need for statutory control of dealers in securities, investment consultants and investment managers; and, finally, to advise on the need for new legislation in the area. Professor Gower was also asked to consider any relevant developments in the European Community.

Professor Gower published a Discussion Document [3] in January, 1982. and a report [4] in January, 1984. They were written at a time of great change in the U.K. securities markets. Even more change in these markets has occurred since the report’s publication.

The aim of this article is to describe the regulatory framework which was in place when Professor Gower began his task, to give an indication of the recommendations and thrust of Professor Gower’s report, and to compare that report with the Government’s views as set out in its recent White Paper. This article takes note of several questions that remain unanswered by the White Paper. It concludes that although the proposed changes may well be inevitable, the dichotomy between regulatory power and the costs of regulation may end up unfairly divided between the Government and the regulated.

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2. The regulatory framework

The focus of the Gower Report and the White Paper is the regulatory framework that existed in the United Kingdom between 1981 and 1984. This framework, which was based on a complex mixture of statutory and self-regulatory provisions, was designed mainly to regulate issues of and dealings in securities, but not to cover other types of investments or investment advice.

The statutory provisions were created piecemeal over the years in response to specific problems and abuses. These provisions were not far-reaching [5] and were generally based on the principle of *caveat emptor*.

Self-regulatory protection is afforded by the Stock Exchange, which has its own rules governing disclosure and the content of circulars; the Panel on Take-overs and Mergers ("the Panel") which supervises the City Code on Take-overs and Mergers ("the City Code"); and the Council for the Securities Industry ("the CSI") which promulgates codes of practice in various areas. There is also significant reliance on the perceived importance on the part of individuals practicing in the field of issues and take-overs of maintaining the highest standards so as to preserve their reputations. Furthermore, there are a number of professional bodies [6] representing such practitioners which exert some influence in maintaining the standards which, to some degree, protect investors.

The result is a complex edifice of statutory regulation and self-regulation which is interlinked and interdependent. Although the structure is complex, it has worked effectively in recent years without giving rise to any major scandal or upheaval. Making the edifice less complex, however, is not easy because the removal of one or two bricks is likely to unbalance the structure as a whole.

2.1. The statutory provisions

2.1.1. The Companies Acts

Until January, 1985, any offer of shares or debentures to the public had to be accompanied by a prospectus that complied with the Fourth Schedule to the Companies Act 1948, and that was registered at the Companies Registry and open to public inspection [7]. Since that date an issue of shares by a Company whose securities are listed on The Stock Exchange must publish listing particulars which must be registered at Companies Registry, so that the prospectus provisions now apply only to issues of unlisted securities. However, the prospectus provisions applied only to an issue for *cash*, and therefore did not, and do not, cover a share exchange offer on a take-over [8]. Moreover, until January, 1985, The Stock Exchange was able to dispense with the prospectus requirement with respect to listed companies if, with regard to "the size and other circumstances of the issue and to any limitations on the number and class of persons to whom the issue is made, it considers compliance with the Fourth Schedule would be unduly burdensome" [9].
In 1980, insider dealing was made a criminal offence [10], and statutory regulation was finally provided in an area heretofore left to self-regulation by the Panel and The Stock Exchange. Much of the initial investigative work, however, continues to be carried out by The Stock Exchange.

2.1.2. The Prevention of Fraud (Investments) Act 1958

The principal statute affording protection to investors in relation to an offer to buy or sell existing securities (as opposed to an offer to subscribe or purchase new securities) in the United Kingdom is the PFI Act 1958, which substantially re-enacted the PFI Act 1939. The 1939 Act was enacted to regulate the proliferation of new companies which resulted from an increase in business activity in the 1930s, and to prohibit a number of frauds involving the sale of shares in worthless companies as well as the offering of facilities for “margin” transactions whereby the investor would be induced to put up cash or securities to cover any “losses” [11].

The 1939 Act contained the basic framework that still applies under the current PFI Act. Among the surviving provisions of the 1939 Act is the requirement that any person carrying on the business of dealing in securities must hold a principal’s license [12]. The Act also gives the DTI the power to refuse or revoke (but not suspend) a license [13] as well as to establish rules for the conduct of business by licensed dealers [14].

Exempted from regulation under the PFI Act are any dealings by members of any recognized stock exchange, by a recognized association of dealers in securities, or by the manager or trustee under any authorized unit trust scheme [15]. Furthermore, under certain conditions the DTI can declare any person to be an exempted dealer [16].

The principal prohibitions of the PFI Act are two criminal offenses. Any person who induces another to enter into a contract relating to the purchase or disposal of securities or other property by making a misleading, false, deceptive or reckless statement, promise, or forecast is guilty of deceptive inducement [17]. Additionally, the PFI Act prohibits any unauthorized distribution of circulars concerning the purchase or disposal of securities or other property [18]. An authorized distribution can be made by either a licensed or exempted dealer or by a person specifically authorized by the Board of Trade (now the DTI).

In 1939 the DTI exercised its authority under the PFI to make rules with respect to the conduct of the business by licensed dealers (“the 1939 Rules”) [19]. Among other things, the 1939 Rules prohibited a licensed dealer from offering to dispose of securities without an accompanying prospectus or statement containing various details of the securities [20]. In addition, the 1939 Rules also prohibited “cold-calling” [21] and laid down rules relating to the issue of contract notes [22] and the keeping of accounts [23].

After the 1939 Act was updated and re-enacted as the Prevention of Fraud
Investor protection in the U.K. (Investments) Act 1958, the 1939 Rules were also repealed. While the 1939 Rules had provided effective control over offers to dispose of securities, they prescribed no requirements for licensed dealer to follow in offers to acquire shares. The Licensed Dealers (Conduct of Business) Rules 1960 ("the 1960 Rules"), which replaced the 1939 Rules, applied to both offers to acquire securities and offers to dispose of them [24]. Additional rights were specified with respect to take-over offers [25].

2.2. Self-regulation

2.2.1. The Stock Exchange

In contrast to North America, the over-the-counter market in the United Kingdom is very small, with the vast majority of purchases and sales of securities being conducted on The Stock Exchange. As a result, The Stock Exchange has become the most important self-regulatory body.

Stockbrokers are obliged to conduct their business in accordance with the rules and regulations of The Stock Exchange, its code of dealing, and its notes of guidance. The Stock Exchange has a disciplinary function with an Appeals Committee and penalties ranging from censure to expulsion. In 1974 financial surveillance of firms was increased [26] and each firm is now obliged to maintain a minimum solvency ratio, to submit annual statements, and to submit a quarterly, unaudited balance sheet [27]. Although the rules for distinguishing clients' funds are not strict, there is a compensation fund and members are required to take out fidelity insurance [28]. In addition, in October, 1981, The Stock Exchange appointed an inspector with power to make "spot checks" on member firms.

As well as regulating the conduct of the market and market dealers, The Stock Exchange prescribes and scrutinizes the information to be supplied when securities are admitted to listing. Through its listing agreement, The Stock Exchange used to impose obligations in addition to those in the Companies Acts, for example periodical disclosure and transactions which have to be referred to the members in a general meeting [29]. The listing agreement has been replaced by the continuing obligations in Chapter 5 of the new Stock Yellow Book, Admission of Securities to Listing.

The Stock Exchange also runs a lower-tier market, the Unlisted Securities Market ("USM"). Although some of the requirements for introduction to the USM are less onerous, those relating to disclosure and publication of information are for the most part similar to those which used to apply to the upper-tier under the listing agreement.

2.2.2. The Panel and the Council for Securities Industry

In 1968, the Panel was set up under the sponsorship of various City institutions to interpret and administer the City Code, which is now in its eighth edition. The Panel deals only with take-over offers and associated
matters. It is concerned with the manner in which a bid is conducted but not with the merits of any bid nor with whether a bid is in the public interest. The Panel also ensures that all equity shareholders are treated equally in take-over offers.

In 1978 the persons operating in the field of securities created the Council for the Securities Industry (CSI). Since then the CSI has played a role in supervising, maintaining ethical standards for, initiating new codes of conduct for [30], and resolving differences between the various segments of the securities industry.

Despite such activities, many in the City believe that the CSI has always been more of a discussion group than a regulatory body [31]. The ambivalent attitude expressed by the City practitioners, especially the merchant banks and The Stock Exchange, reflects the fact that even though these institutions are members of the CSI, they have never accepted that it had authority over them.

3. Reasons for the review of the regulatory framework

3.1. The PFT Act's shortcomings

The PFI Act came into being as a result of the share-pushing activities of some in the 1930s. The Act was not intended to lay down universal rules as to the disclosure required and the contents of documents, but instead was designed to achieve its goal by trying to ensure that only fit and proper persons dealt in securities. The result was a regime which excepted from the scope of the regulation persons who were members of a self-regulatory system (i.e., members of The Stock Exchange and other recognized associations of dealers in securities). Other persons were required to be licensed by the DTI to deal in securities.

However, the Act also provided for exempting those who dealt only incidentally in securities. Although it was originally anticipated that only a few institutions and practitioners would be exempt, most merchant banks, clearing banks, and a number of others successfully established that dealing in securities was ancillary to their principal business and that they should therefore be exempt. Consequently, these institutions and firms could circulate offers and take-over documents as part of their overall corporate finance business [31]. Over time the number of exempted dealers grew such that, as Professor Gower points out, the exemption "has come to be regarded as a prized status symbol" [32]. The perceived advantage of being an "exempted dealer" was that the detailed rules and regulations which applied to licensed dealers did not apply to the exempted dealer, even though the Department of Trade was obliged in November 1977 to write to exempted dealers informing them that the DTI expected them to comply with the licensed dealers' rules [33].
Over the years, the narrow scope of the PFI Act and the 1960 Rules became an increasingly apparent shortcoming. Persons who were investment advisers, but not dealers, and investments which did not come within the Act’s definition of securities were left outside the regulatory scope. Moreover, the “exempted dealers” were largely unregulated as a result of the unintended distinction between them and licensed dealers. Also, the exemption for “professionals” was widely abused.

The measures relating to unit trusts were a further unexpected legacy of the PFI legislation. These measures were originally intended as temporary ones, but were never replaced. The DTI then assumed complete control over the establishment of new “authorized unit trusts” [34] and the variation of their trust deeds. As a result, a vast body of law and practice evolved which has never been published and which is known in detail only to DTI officials. Consequently, the authorized unit trust is the most heavily statutorily regulated investment medium in the United Kingdom [35]. Other shortcomings included the PFI Act’s failure to define what constituted a circular, which raised questions as to whether newspaper advertisements were covered by the legislation. Finally, there was no provision for civil liability for the making of a false or reckless statement, nor did the DTI have the ability to suspend licenses; they either had to grant or re-new them, or revoke them entirely.

3.2. The scandals of 1981

In addition to the perceived shortcomings of the PFI Act, certain scandals occurred in 1981 which demonstrated that a comprehensive review of investor protection was needed. Two incidents demonstrated the conflict of interest which can arise in firms that manage the investment of others.

In March, 1981, an investment management company collapsed with a deficit of some £2.5 million, causing its clients significant losses. The company had invested some of its clients’ money in its own group of companies, which subsequently failed [36].

In the same month, The Stock Exchange formally appointed a Committee of Investigation to inquire into certain dealings by a firm of Manchester stockbrokers. It had been alleged that certain members of the firm were using one of its accounts as an “open account” for the transfer of money to various clients on the basis of fictitious actions [37].

In both cases the problem was one of conflict of interest relating to people whose job it was to manage the investments of others. The 1960 Rules, however, did not have any detailed provisions requiring disclosure of conflicts of interest. The first case also shows that once the Department of Trade certifies a company as a licensed security dealer, the company’s customers may have very little protection. If no complaints are filed with the Department of Trade, then no questions are asked.
In the following month a firm of London stockbrokers collapsed. The collapse was partially due to an outstanding debt of one of its investment management clients. The losses were covered by The Stock Exchange's compensation fund [38].

In December of 1981, a firm of commodity brokers went into liquidation with an estimated deficiency of some £2.8 million. The firm owed its clients a total of £1.133 million; their funds had not, however, been kept in a separate “trust” account and were therefore available to the firm’s creditors [39]. Under the law, the Department of Trade had no control over commodities brokers.

4. The Discussion Document

In January, 1982, following a series of informal discussions with a number of professional bodies and individuals, Professor Gower published a “Discussion Document” [40]. In the introduction to the Discussion Document, he stated that this review was being undertaken in conjunction with the revision of the 1960 Rules. The changes to the 1960 rules were specifically aimed at the rules relating to the custody of investors’ funds following the collapses in 1981. Unfortunately, it was not possible to amend or extend the structure created by the PFI Act without new primary legislation. Professor Gower was appointed to suggest the necessary changes to the legislation.

4.1. Scope of the review

The object of Professor Gower’s review was “to consider whether the existing system of disclosure plus regulation provides adequate protection in an efficient and economical way and, if it does not, what should be done about it” [41]. He also intended to analyze the degree of protection enjoyed by persons engaged in investments other than securities. In some areas, such as life assurance, there was no regulation, whereas other investments, such as authorized trust units, were overregulated. Thus, the review would have to include investment in commodities, pension funds, building societies and provident societies, banking and deposit-taking institutions, and government securities as well as securities.

Professor Gower rejected the caveat emptor approach to investor protection, suggesting instead that an investor could only be “at fault” in those cases where he could judge the extent of the risk about to be undertaken [42]. He dismissed the possibility of requiring only greater disclosure because that would only assist “sophisticated investors” and would not prevent loss caused by deliberate fraud.

Professor Gower considered the domestic changes that occurred in the
securities industry over the fifty years leading up to his paper. There had been a shift from direct personal investment in securities to indirect investment through life policies, unit trusts, commodity and futures funds and occupational pension schemes. The influence of tax considerations on investments decisions had increased. Additionally, there had been greater distortions caused by the different methods of remunerating intermediaries (e.g., the difference between paying a stockbroker's commission and taking out a life policy). As a result of these complexities, firms had been established solely to manage and advise on investments.

International events also had done much to shape the securities industry. Following the removal of exchange controls in 1979, much investment had been effected in international markets. This led to the growth of multinational groups offering a full range of financial services. There had also been directives and proposed directives from the European Economic Community (EEC) concerning various aspects of the different investment industries, all of which would have to be implemented [43]. In light of such events, Professor Gower concluded that some increase in statutory, as opposed to non-statutory, regulation would be inevitable in the long term.

The Discussion Document outlined the present forms of statutory and non-statutory regulation and came to some preliminary conclusions. First, there was no overall system of regulation of investment media and the securities industry in the United Kingdom. Although disparate attempts had been made to regulate certain aspects of the investment industry, it was difficult to determine why one method of regulation was chosen rather than another in any particular area. The result was to "blur the distinction between governmental regulation and self-regulation, and between statutory and non-statutory regulation" [44].

Moreover, the overall tendency in statutory controls was towards regulating the entities which create investments (banks, insurance companies, and building societies) instead of the market in which the securities are traded or the intermediaries who sell them or advise on their sale. Finally, Professor Gower pointed out that the present system was difficult to enforce effectively. The existing statutory regulation depends upon criminal proceedings which require a high standard of proof and thus have a low success rate. Self-regulation, on the other hand, depends on such non-legal sanctions as adverse publicity, suspension of listing, and expulsion from the "club".

4.2. Defects of the present regulatory system

Professor Gower's principle criticism of the present system of regulation was that similar types of investment are treated in a dissimilar manner. This was partly a result either of policy or of the inherent defects of the PFI Act compounded by both innovative thinking on the part of those who were
marketing investments and the insufficient flexibility on the part of statutory authorities to remedy these problems. Examples included the different treatment of authorized unit trusts and open-ended "off-shore" companies [45], the different treatment of unit trusts and life assurance policies [46], and the differing extent to which "prospectuses" are regulated depending on the circumstances of the issue [47].

Professor Gower was also critical of the "fringe and elite" which evolved as an unexpected result of exempting people from the PFI Act provisions, and because of the nature of the professional associations which formed the backbone of the self-regulatory system. The "elite" is made up principally of the stockbrokers and merchant bankers, who are exempted dealers and subject to their own rules, and are largely left to run their own affairs. The "fringe" is composed of those who are licensed dealers under the Prevention of Fraud Act. "In sophisticated City circles, licensed dealer status ... is regarded almost as a slur, suggesting that the firm concerned is a fringe operator that is hardly to be trusted" [48].

Professor Gower further commented that the industry had criticized the DTI for lax enforcement of the PFI Act. In addition to being criticized for delays in the granting of licenses, the DTI was faulted for the failure to revoke a license where the dealer was considered to be unsatisfactory.

Professor Gower also believed that licensing in itself may give an impression of strong regulation where none previously existed. He expressed concern that the present system was designed to weed out the dishonest, but not the incompetent.

As part of the review, Professor Gower identified the advantages and disadvantages of self-regulation. He noted that self-regulation allows for a certain degree of flexibility and the ability to make decisions quickly. Self-regulation is also advantageous in that it uses the personal expertise of those involved in the operations to be regulated. Additionally, a system of self-regulation is not limited to the letter of its rules, but provides the ability to deal with infringements of the "spirit", thus ensuring high standards. Finally, self-regulation makes lesser demands on the public purse.

Among its disadvantages, self-regulation carries with it the risks of imprecise and vague rules. There are also difficulties with effective enforcement over non-members and over those who are not concerned with the possibility of losing their membership or damaging their reputation. Furthermore, self-regulation could insulate those involved from public, as opposed to professional, opinion. Finally, there is always the danger that self-interest will outweigh public interest, or at least will appear to do so. Given these advantages and disadvantages, Professor Gower concluded that it was the role of government to decide the major questions involving public policy but that discretionary power over day-to-day regulation is better handled by the self-regulatory agencies.
4.3. Possible lines of reform

Professor Gower believed that in making any decision it was important to bear in mind the two-fold policy of the present Government to reduce the size of the Civil Service and cut costs. Any reformed system must also aim to maintain the City of London as a viable international centre for financial services. The regulations, therefore, should be no stricter than that of comparable centres.

He also believed that the principle of *caveat emptor* had to all intents and purposes been rejected. Although he accepted the distinction between the individual and the true professional dealer, Gower thought that it was not attractive to have a regime which distinguishes between different sorts of purchasers (e.g., rich and poor). Prevention was better than retribution and some form of compensation fund was required.

Professor Gower outlined five possible approaches to his task and then proceeded to dismiss the first four. The first option—to do nothing—was not possible since he was of the opinion that something needed to be done.

The second option involved a revision and extension of the PFI Act. Gower argued that such a revision by itself would do very little to promote consistency throughout the field. Moreover, it could well cause an increase in the amount of Civil Service manpower (and thus costs) required to regulate the large number of investment consultants and advisors.

The third alternative was to consolidate the existing PFI Act with the sections of the Companies Acts which dealt with issues of securities. He rejected this option because it "would do nothing to establish a more coherent and better balanced relationship between Governmental and self-regulation" [49].

The fourth option was to set up a Securities Commission. Although Professor Gower preferred this choice, he rejected it because it was not "practical politics" [50].

This left his fifth proposal, which was to create a new system involving both governmental regulation and self-regulation. This was a compromise designed to minimize the disadvantages of self-regulation. Enforcement would be improved by giving self-regulatory agencies the backing of statutory powers and keeping self-interest at bay by making such agencies subject to overall statutory control. The new system would have the additional benefit of taking away day-to-day supervisory functions from the DTI, which would be consistent with cost-cutting and Government policy.

He went on to propose a new regulatory framework consisting of four self-regulatory agencies based on functional lines, one for dealings on The Stock Exchange, one for dealings off The Stock Exchange and investment management advice, one for unit trusts, and a take-over and issues agency. The CSI was suggested as an "umbrella body" to co-ordinate and supervise the new agencies.
5. Developments during the period between the Discussion Document and the Gower Report

5.1. The Licensed Dealers (Conduct of Business) Rules 1983

Following the collapses in 1981, the DTI drafted new conduct of business rules to replace the 1960 Rules. The 1983 Rules [51] were finally declared effective in June and September of 1983.

While the 1983 Rules impose rules relating to clients' money, requirements for investment management contracts and, in particular, disclosure of material interest, they eliminate the detailed requirements for the contents of circulars offering to purchase or sell securities which had been a feature of the 1960 rules. These requirements are replaced by a statement that "to the extent that there exist generally accepted standards as to what constitutes good market practice in respect of any matter not expressly covered by these rules a licensed dealer should comply with such standards" [52]. The purpose of this statement is to subject licensed dealers to the non-statutory rules of self-regulatory bodies, principally the City Code.

The ambit of the City Code was also expanded to cover certain categories of private companies (having covered only public companies to that date) [53]. A "general permission" was published under the provisions of the PFI Act that allowed the publication of a circular offer by anyone (not just a licensed or exempted dealer) in relation to companies not covered by the City Code [54].

5.2. The EEC admission directives

Professor Gower asserted in his Discussion Document that the implementation of the EEC directives [55] concerning the admission of securities to listing would alter the balance between statutory control and self-regulation. At the time of the Discussion Document this was a matter of some debate. It had originally been thought that the Stock Exchange could be nominated by the DTI, or the Government, as the "competent authority" for the purposes of the directives without any formal legislation. It became clear, however, that legislation would be brought forward, in the form of a Statutory Instrument made under the European Communities Act 1972. The Stock Exchange Listing Regulations were published in May, 1984, and became effective in June, 1984, for securities offered by or on behalf of the Government, and in January, 1985, for all other listed securities [56].

5.3. Stock Exchange—Restrictive Practices

In 1976 the Restrictive Practices legislation was extended to cover agreements relating to the provision of services [57]. This meant that the Rule Book
of the Stock Exchange had to be registered as an “agreement” between its members. The Office of Fair Trading, whose task it is to review registered agreements, challenged the Rule Book, listing 173 “restrictive practices.” The major areas of challenge were minimum commissions, separation of capacity, and access to membership.

The Stock Exchange argued that fixed commissions—a minimum percentage commission levied on any transaction in accordance with a range of rates—were essential to ensure the observance of “single capacity” (i.e., the separation of stockbroker and stock jobber) [58]. The “single capacity” system was acknowledged to be one of the major investor protection safeguards because it cut out the potential conflict of interest that could arise where the stockbroker, the client’s agent, also had an interest in acting as a principal. The Stock Exchange argued that negotiated commissions would force stockbrokers to act on their own account buying and selling stocks to get business. This would lead first to the need to “match” [59] business between clients without the costs of a market “put-through” [60], and then to competitive market-making between brokers.

It was also argued that the abolition of minimum commissions would almost certainly lead to fundamental changes in the nature of the securities market. Potential effects were said to be fewer firms [61], greater fragmentation of the market, and an increase in foreign ownership of the firms operating in the securities industry [62]. In turn this could reduce the capacity of The Stock Exchange to regulate security dealing and finance its services, notably the compensation fund.

The Stock Exchange finally agreed to abolish minimum commissions, to introduce “lay members” to its Council, and to set up a new independent appeal body in return for the Government exempting the Exchange’s Rule Book from the restrictive practice legislation.

6. The Gower Report

6.1. Introduction

In the midst of these changes Professor Gower published his Report. He claimed that the responses to his Discussion Document revealed a clear consensus in favour of a comprehensive system of regulation within a statutory framework based as far as possible on self-regulation subject to government surveillance [63]. This contrasts strongly with the published responses from “the City” as a whole [64]. Professor Gower stated that it seemed “clear … that, if self-regulation is to survive, the surveillance to which it is subject must be sufficient to provide a genuine curb on undesirable restrictive practices and a sufficient spur to ensure rules are kept under review and their observance efficiently monitored” [65].
He also reasserted his basic philosophy that the regulation should not seek to "achieve the impossible task of protecting fools from their own folly"; instead, regulation "should be no greater than is necessary to protect reasonable people from being made fools of" [66]. He emphasized that it would be self-defeating to impose restrictions so severe that they would be stricter than those in competing financial centers and could only be complied with at great expense.

6.2. Professor Gower's proposal

Consistent with the conclusions of his Discussion Document, Professor Gower advocated a system based on Self-Regulatory Agencies ("SRAs"), each responsible for supervising a particular area of activity but with statutory backing. He was aware, however, of some of the problems with this proposal. Some firms would need, or wish, to be registered directly with the DTI rather than with an SRA. In addition, for the time being, an SRA would likely be based upon present professional and commercial groupings rather than the type of business in which its members are engaged. This might mean a larger number of SRAs than would be effective. Moreover, a number of firms would have to belong to more than one SRA [67].

In response to these problems, he suggested that the PFI Act be replaced by an Investor Protection Act (IPA). Under the IPA, a governmental agency would be responsible for overall surveillance and residual regulation of investment business. Day-to-day regulation, however, would be left to the SRAs or the governmental agency for those registered with it [68]. It would be a criminal offense to carry on an unregistered investment business [69].

6.2.1. The governmental agency

The Report also discussed whether the governmental agency should be the DTI or a self-standing commission similar to the Securities and Exchange Commission of the United States (SEC). Gower concluded that a self-standing commission would have more expertise, be more distant from the Government, and closer to the SRAs and the City. Such a commission, however, could only be justified on cost grounds if it has a substantial workload. Professor Gower therefore concluded that the governmental agency should be the DTI unless it became apparent that there was a substantial volume of day-to-day work that would justify a self-standing commission (e.g., because many people wished to register directly rather than through an SRA). In such a case, the DTI would remain responsible for overall surveillance and for making any regulations which give rise to criminal sanctions. He also modified the role he had foreseen for the CSI in his Discussion Document. Whilst the central regulatory role would now be for the governmental agency, he still envisaged a general co-ordinating role for the CSI, especially if the number of SRAs was to be far
larger than the few he had originally envisaged. However, he recommended that the CSI must strengthen its infrastructure and its authority.

6.2.2. Criteria for recognition, and role and authority of SRAs

Before the governmental agency [70] would recognize an SRA, there would have to be a need for the SRA in the relevant field. The SRA must also establish fair and reasonable rules and practices relating to admission [71], suspension, expulsion, and discipline of its members. Rules for conduct of business that give investors adequate protection at least equal to those of the government agency should also be established. Professor Gower suggested that these rules should be fashioned after the Licensed Dealers (Conduct of Business) Rules 1983. Above all, the Rules should provide for “full and frank disclosure in circumstances where there is a conflict of interests or of interest and duty” [72]. The rules, however, should not go so far as to impose restrictions on competition which are greater than necessary for the adequate protection of investors and the orderly conduct of the relevant business or market. The SRAs must also have procedures and resources that enable them to effectively monitor and enforce observation of the rules. The constitutions of the SRAs should provide for the independence of their governing bodies from the sectional interests of their members. The constitutions should also provide effective procedures for investigating complaints against themselves or their members.

He also recommended that the SRAs be empowered to subpoena witnesses and to compel the production of documents in disciplinary proceedings. All information received and findings made during such proceedings should be protected from actions for defamation and breach of confidence.

Professor Gower discussed the possibility of requiring SRAs to have either a compensation fund or insurance. Though he strongly suggested that such protection be established for investors, he did not think it was essential. At a minimum, there should be proper segregation of a client's money from the firm’s money. The client’s money should be held in trust so that it would not be available to general creditors of the firm in the event of liquidation.

6.2.3. Scope of regulation

The Report includes the following recommendations concerning the scope of regulation for the different investment fields.

6.2.3.1. The type of investment to be covered. Professor Gower recommended that all forms of investment, other than investments in physical objects over which the investor would have exclusive control, should be covered by the IPA. Such investments would include contracts for commodity or financial futures, options, and life assurance contracts. Under the IPA the definition of securities would include investments such as stocks, shares, bonds, and debentures.

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A particular problem under present law is the difficulty of defining what a gaming contract is because there is no clear legal distinction between gaming contracts and investments in futures or options. The Act, therefore, should draw a clear distinction between gaming contracts, which are unenforceable under English law, and investments [73].

6.2.3.2. Extension of regulation to all investments. Professor Gower also considered the regulation of those dealing in commodity and financial futures. During the drafting of the Report, the Association of Futures Brokers and Dealers was being formed. Professor Gower hoped that this Association could be recognized as an SRA. The Bank of England's traditional role of surveillance of the Commodity and Future exchanges for market efficiency in relation to the monetary system would not be affected.

6.2.3.3. Scope of “professionals only” exemption. The Report also concluded that private and professional investors should receive the same protection. Presently under the PFI Act, “professionals only” were exempted from the protection of the Act. In Professor Gower's opinion, however, the exemption had been abused. As a result, it is had become impossible to insulate those who are not true “professionals” from invitations to invest which are based on scant information. Professor Gower recommended that the exemption apply only to those who carry on an investment, banking, or insurance business. He also suggested that rules of conduct be established to ensure that the professionals do not advise their non-professional clients to buy or sell such investments unless the professionals have “adequate and reasonable grounds for their advice and have considered the suitability of the investment for the person being advised” [74].

6.2.3.4. Investment exchanges. The Gower Report calls for some regulation over the type of entity that could be called an “investment exchange.” It would be unlawful for any entity not recognized as an investment exchange by the governmental agency to carry on business as an investment exchange in the United Kingdom.

Professor Gower suggested that it would neither be necessary nor desirable for the Eurobond market to be regarded as an “investment exchange,” partly because it is largely a “professionals only” market. Dealers on the Eurobond market, however, could not be totally excluded from regulation because there are increasing sales of Eurobonds to private investors. He therefore suggested that the professional associations involved in dealing in Eurobonds convert themselves into a SRA and register directly with the governmental agency. An alternative solution might be to appoint the Association of International Bond Dealers (which is a Swiss-based Association) as the SRA, or to recognize only the U.K. branch of it.
6.2.3.5. The position of life assurance business. Professor Gower examined in considerable detail the types of regulation of life assurance and unit trusts, the marketing of which raises a number of problems. The commission paid to intermediaries often leads to the sale of investments that benefit the intermediary more than the purchaser. Insurance companies lack control over their agents because the agents are self-employed intermediaries, which allows insurance companies to distance themselves from the acts of their agents. Hard-sell marketing methods used by those agents, such as "cold calling" are difficult, if not impossible, to monitor.

Regulation of these types of investments posed a problem for Professor Gower. In particular, he criticized the sales of investments by unauthorized off-shore insurance companies. Some of these investment products are linked to highly speculative property such as unmined gold and untapped energy. Presently, overseas registered life insurance companies can freely market their investment products in the United Kingdom with minimum control by the Department of Trade. The company only need make it clear on its promotional literature that it is not registered in the United Kingdom.

It is not possible to require insurance companies from EEC Member States to submit to a registration regime. Accordingly, Professor Gower suggested as a solution that regulation should be effected by making it an offense to advertise or circulate long-term insurance business unless the advertisement or circular complies with the advertising regulations under the Insurance Companies Act 1982.

Professor Gower made several recommendations for the regulation of long-term insurance business. A Code of Conduct should be established to impose "cooling off" periods [75], to regulate cold-calling, and to ban unsuitable salespersons. Independent intermediaries should be registered and insurance companies would be held responsible for the salespersons they employ. Professor Gower would also bring long-term insurance business within the IPA as far as possible. Under the IPA it would be an offense to promote products of unauthorized companies. He also recommended that the same underlying investments be permitted for all types of investment media. The rules relating to the creation of and offers to the public of authorized unit trusts and other mutual funds should be conformed. Finally, the DTI's scrutiny of unit trusts should be relaxed.

6.2.3.6. Regulation of public issues and offers. The Report recommended that the statutory provisions in the Companies Acts relating to public issues, take-overs, and insider dealing should be transferred to the IPA. Gower suggested that invitations to the public, whether in connection with a primary or secondary distribution [76] or a take-over, should be treated similarly.

His principal recommendation in this area was that any document containing an invitation to the public should be "pre-vetted." This would entail
vetting all take-over documents and primary and secondary issues, which are presently pre-vetted only if the company is either listed on The Stock Exchange or has its shares dealt in on the USM. The pre-vetting agency would have to grant “permission to issue.”

The Stock Exchange should continue to pre-vet the issue of securities on its own listed market and the USM and the CSI should establish a body to pre-vet issues by member bodies other than The Stock Exchange. The governmental agency would deal with issues by those who were not members of an SRA.

The Discussion Document had suggested that the role of the Take-over Panel be extended to conduct all pre-vetting. Professor Gower had realized, however, by the time he wrote his Report that this would not be practical since The Stock Exchange would not give up its role in relation to its own markets. However, he also foresaw that those who registered directly with the governmental agency would not be willing to submit to pre-vetting by either The Stock Exchange or the CSI.

The division of responsibility relating to the monitoring of take-overs would remain roughly as it is now between the Panel and the DTI.

Professor Gower went on to recommend that it should be possible to revoke permission for a public issue where it subsequently became clear that the prospectus was misleading or incomplete.

6.2.3.7. Company law. Professor Gower went on to suggest certain changes in the present statutory provisions relating to company law. These changes could be incorporated in the IPA. These would eliminate differences between issues of the securities of domestic companies and of foreign companies, between those of listed and unlisted securities, and between those relating to primary and secondary distributions. Further recommendations relate to changes in the laws relating to compulsory acquisition [77] and compensatory payments to directors on termination of their employment [78]. Additionally, insider dealing provisions should be extended.

6.2.4. Investigation, enforcement, offenses, and sanctions

One of the major problems with the present regulation is the difficulty of enforcement. One reason is the failure of the governmental and self-regulatory investigative authorities to pool their resources, which is in part due to the different nature of the powers each authority has. Professor Gower recommended, therefore, that the governmental agency and the SRAs be required to make available to each other any information gathered in the course of official investigations.

He stressed that inspection powers, if effectively used, would help avoid any violations of the law. Before authorizing someone to carry on an investment business, the authority should satisfy itself that a person is “fit and proper” to do so. Also, the governmental agency or SRAs should have the power to carry out “spot checks” on the books and papers of any person registered with them.
or any person suspected of engaging in investment business without being registered. The monitoring and vetting responsibilities of SRAs would likewise be a valuable preventive function. Professor Gower even advised allowing SRAs to monitor the practices of non-registered persons to see if they should be registered.

In order to make the investigatory power effective, it would be necessary to provide for speedy remedial action such as revocation or suspension of registration. The governmental agency should also be able to intervene in an investment business when necessary to protect the clients from further losses. Such intervention would include prohibiting dealing with assets or vesting power over the assets in a trustee, and forbidding the firm from entrance in specified transactions or solicitation of business from those who are not regular clients.

Professor Gower noted that provisions similar to the two criminal offenses in the PFI relating to deceptive inducements and distributions of investment circulars [79] should be included in the IPA [80]. The deceptive inducement section should cover all investments. A publisher of a newspaper or periodical should be held liable for publishing an investment advertisement in the ordinary course of business unless he had no reason to believe it contained an invitation to invest or he had reasonable grounds to believe it was placed by a person entitled to do so [81]. A publisher, therefore, would have the obligation to check the register to determine who is entitled to place such an advertisement. With respect to circulars, the “professionals only” exclusion would still apply.

Any breach of the IPA or regulations made thereunder would also be considered an offense. Under Professor Gower’s proposals, it would also be an offense if a firm which is registered for investment business did not state so on its letterhead. The IPA should also provide a civil remedy for persons who suffer loss as a result of breaches of the IPA or its regulations [82].

Professor Gower went on to recommend further review into the effectiveness of juries in long and complex commercial fraud cases. Although he does not think substituting a jury with lay assessors having relevant experience would be politically possible, he nevertheless posed it as a possible solution. One solution he believed might be politically acceptable would be to use the magistrate’s courts [83] whenever possible to obtain a speedy conviction of criminals on a lesser offense, such as a breach of the regulations, instead of trying to obtain further evidence needed for a more serious charge. He recommended that the maximum fines a magistrate could impose should be increased.

6.3. Professor Gower’s conclusions

“The system which the recommendations propose needs to be accepted (or rejected) as a whole and (if accepted) to be brought into operation without
delay” [84]. Although these recommendations are a compromise from his earlier suggestions, Professor Gower clearly wanted to avoid further compromises. “Further truncation would destroy whatever merits the scheme may have” [85].


The debate on the best way to regulate the securities industry intensified following the publication of Professor Gower’s Report in January 1984. In the preface to the report, Norman Tebitt, the Secretary of State for Trade and Industry, had invited interested parties to submit comments on Professor Gower’s recommendations in anticipation of the Government finalizing its own preferences and publishing a White Paper in the Autumn of 1984.

By mid-1984, however, the focus of the debate had begun to shift away from the issues of controlling investment managers and advisers to the question of how to control conflicts of interest across a much broader area. This concern arose out of the realignments between banks, stockbrokers, investment managers, stockjobbers, discount houses, and others in the financial community in London brought about by the prospect of the end of minimum commissions and single capacity [86]. Efforts were first made to try to establish the CSI as the U.K. governmental agency, but it became clear from a number of comments on the Gower Report submitted to the DTI and made public, that the CSI did not have sufficient support from the most influential practitioners, most notably the leading merchant banks which made up the prestigious Accepting Houses Committee, to enable it to play the “coordinating” role envisaged by Professor Gower.

In an effort to force the City to produce its own solution, two advisory groups were formed. The Governor of the Bank of England asked a group of ten leading City practitioners to advise him on the structure and operations of a practitioner-based regulatory system. Secondly, the DTI asked the chairman of the Life Offices Association to form a group whose purpose was to advise on the prospects for practitioner-based regulation of the marketing of life assurance and unit trusts.

During the year a number of further “mergers” between stockbroking firms and other financial institutions were announced and the subject of the potential conflicts of interest which could arise for such entities was debated endlessly in the press. One feature of this debate was the degree to which the new “financial conglomerates” would be able to rely upon the “Chinese Wall” principle by which internal controls are used to ensure that sensitive information remains locked in separate departments of the organization. Recognized in law for the first time in the 1980 Conduct of Business Rules, this concept was
not universally approved as an effective means of preventing the leakage of price-sensitive information. It was, however, a cornerstone of the argument put forth by merchant banks and brokerage firms in support of their participation both in investment management and corporate finance. With the potential addition of a market-making function, the need for information to be isolated became even more pressing. Mr. Alex Fletcher, Under-Secretary of State for Corporate and Consumer Affairs at the DTI, continued to insist that it was for the self-regulatory system to remodel itself along the "Gower" lines.

During the summer of 1984 the DTI waited for the financial services industry to reach a consensus on a future self-regulatory framework. Meanwhile, the financial services industry waited for the DTI to give an indication of the extent of its support for the Gower Report.

By October, 1984, the views of the two advisory groups had filtered through to the DTI and Alex Fletcher announced that the Government was thinking along the lines of introducing two self-regulatory bodies with statutory backing. One would cover the securities investment and futures industry with a membership of practitioners, users, and independent businessmen. The other would cover the life assurance and unit trust industries.

8. The White Paper

In January, 1985, the Government published its White Paper on Financial Services in the United Kingdom [87]. With certain exceptions, the most important of which concern the question of pre-vetting and the protection to be afforded to professionals, the Government appears to have accepted the vast majority of Professor Gower's detailed recommendations [88] and, more importantly, to have embraced his approach and the majority of the principles which he set out for the reform of the regulatory system: that like should be treated alike; that prevention is better than cure; and that effective codes of conduct should be required [89].

The White Paper is not by any means a complete document, and much of the detail will only become clear when the Government publishes the parliamentary bill which will be introduced in the 1985–86 parliamentary session. Nonetheless, the document does say enough to give a reasonably clear picture of the intended structure [90], the principles to be applied [91], and the attempted balance between protecting the relatively unsophisticated investor and permitting the markets to operate flexibility [92]. These twin objectives appear to be at the heart of Government thinking about the securities markets—to encourage the private investor back to direct ownership of securities, which investor protection and the elimination of conflicts of interest is intended to aid, but to leave the "professional" market as untrammelled as possible in the interest of encouraging business. The White Paper thus states:
The regulatory framework outlined in this White Paper gives proper prominence to this time-honoured principle of *caveat emptor*. But it recognises that *caveat emptor* alone is not enough. For investors to have the 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 [93].

8.1. Objectives of the new system

The Government stated that its objectives in designing the new framework were efficiency, competitiveness, confidence, and flexibility [94]. It considered these objectives to be best met when certain principles were followed. For instance, the Government emphasized the need for full disclosure about the investments and services on offer as well as the promotion of competition among practitioners [95]. Furthermore, the law should be logical and clear and should treat like alike [96]. Emphasis was placed on the application of high standards engendered by self-regulation as a means of prevention of fraud [97]. Finally, where such prevention failed, the Government called for vigorous enforcement [98].

8.2. Structure

Any structure proposed by the Government has been expected to take account of two policy matters. First, it was originally thought that a Securities Commission was not practical politics [99], especially for a Conservative Government which is traditionally thought to rely for support on the City. Although the Government has therefore had to bear in mind the political effect of imposing a statutory regime, to some extent it has been able to take the Gower line that in relation to the Stock Exchange, at least, this step has become inevitable as a result of the EEC directives on listing requirements and continuing obligations [100]. The second consideration was cost. The Government has been committed to reducing public expenditure and it has always been its intention that any new regulatory system should not be paid for out of public funds [101].

The structure of the regulation proposed in the White Paper fulfils both these aims. Although necessarily different from Professor Gower's suggestions, given that the City was unable to agree on the CSI as its representative for the role of governmental agency, the White Paper nevertheless follows the two principles advocated by Gower, namely a mixture of self-regulation and statutory backing [102], and a requirement that it be self-financing [103]. Instead of legislation empowering equally a governmental authority and self-regulatory agencies, the White Paper proposes two boards, the Securities and Investments Board (SIB) and the Marketing of Investments Board (MIB) [104]. This seems to amount to a shift marginally further towards Professor Gower's original preference for a self-standing commission with full power [105]. The membership of the two boards will consist of practitioners, users, and other lay
members [106], and each will require an executive which is likely to be made up of some full-time employees and some persons on secondment, as is currently the case at both the Panel and The Stock Exchange. The chairman of each board will be appointed by agreement between the Secretary of State for Trade and Industry and the Governor of the Bank of England [107]. There will a three-person tribunal, chaired by a legally qualified person, to decide on appeals from the boards [108].

Since the publication of the White Paper there has been much press comment and some City opinion to the effect that there should be only one board with authority across the whole range of activities. Alex Fletcher stated on February 6, 1985, that, as the White Paper itself had indicated [109], the Government would consider representations to this effect, although he considered that in the initial stages quicker progress might be made if the burden were to be divided.

8.3. The system of regulation

With certain minor exceptions, the Government accepted Professor Gower's recommendations. A new Act will provide for the Secretary of State to have the power to authorize persons to engage in investment business, and to lay down requirements for the conduct of these businesses [110]. Although there are some minor areas in which the White Paper does not go as far as Gower, it is accepted that the definition of "investments" be broadened as Gower recommended and that "investment business" be defined [111].

As recommended by Professor Gower, life assurance policies and units in unit trusts are to fall within the scope of the regulation [112]. However, insurance companies would not need to be separately authorized by the boards. Current DTI authorization under the Insurance Company Act 1982 would suffice [113].

The Secretary of State will be empowered to delegate his powers to the boards, who would thereby become legally entitled to recognize other self-regulatory organizations (SROs) and thus confer on their members the ability to conduct investment business. The boards would also have the authority to regulate the rules and practices of the SROs. As the White Paper states, "to provide for a statutory power of authorisation and regulation to be given to a private sector body is unprecedented. The bodies will be enabled to make rules with the force of law and to ensure that businesses comply with them" [115].

Such power, however, will also carry accountability. The Act will accordingly require the boards to report annually to Parliament and the Secretary of State will reserve the power to withdraw the authority he has delegated, and to require a board to change or withdraw rules which are considered to be contrary to the interests of competition (if the Secretary of State has been so advised by the Director General of Fair Trading), or where they are contrary to the international obligations of the United Kingdom [116].
8.4. Criteria for recognition

The Boards would need to appear to the Secretary of State to meet certain criteria which are by and large those suggested by Professor Gower [117] as the minimum for recognition with respect to an SRA (i.e., proper review and complaints procedures, compensation arrangements, the ability to monitor and enforce its own rules, the separation of clients’ funds, and so forth) [118]. Two of these criteria are that all investment businesses should demonstrate, to the boards or to an SRO, that they are “fit and proper”, and that each board or SRO has proper rules for the conduct of business [119].

The White Paper deals at some length with the principles which should form the basis of conduct of business rules, preferring to leave the boards and the SROs to formulate the detailed rules themselves [120]. In particular, it sets out in some detail the safeguards which it envisages that the legislation would provide in the area of conflict of interests.

The first safeguard would be a principle of fair dealing which is intended to be the basis for specific rules prohibiting unfair practices and requiring investment business to be conducted in accordance with good market practice [121]. Second, there would be a duty of skill, care, diligence in the provision of investment advice and the transaction of investment business [122]. Finally, there would be a duty to disclose various matters including any material interest which the investment business had in a proposed transaction, the capacity in which it would act (e.g., whether the client would be employing the person as agent to acquire investments on his behalf from another, or as principal buying the investments for its own account or selling them to the customer from its own book) [123].

In addition, when an investment business acts as agent, the general rules of agency and the consequent fiduciary duties would apply. The White Paper suggests that there should be a best execution principle whereby all instructions from a client must be executed to the client’s best advantage (i.e., no investment business could deal with a client from its own book unless this resulted in better terms for the client) [124]. The White Paper further recommends a subordination of interest requirements (i.e., that a client should be given priority in the execution of orders when an investment business is also dealing on its own account) [125].

The Act would require full disclosure in a number of areas, including conflict of interest, terms and conditions of business [126] and, in the area of life assurance, the rates of commission [127].

8.5. Professionals

One area in which the Government has not accepted Professor Gower’s recommendations is in the area of the protection required by “professionals.”
Gower had recommended that the "professionals only" exemption had been abused and was difficult to police, since there was no effective definition of who was, and who was not, a professional, and no means of preventing professionals passing information on to others who were not [128]. Whilst accepting these arguments, the White Paper insists that the principle of a "professionals only" exemption fits well with the Government's concern to avoid over-regulation [129]. It therefore intends to extend the "professionals only" exemption to all investments and to allow for the creation of a new type of unit trust to be known as a "restricted unit trust" which would replace the unauthorized unit trust. No prospectus need be published (which the White Paper introduces as a requirement for the authorized unit trust) if the unit trust is open only to professionals and the range of investments would not be limited [130]. Moreover, the ability to distribute circulars to professionals would be retained and extended [131]. Whilst accepting that the policing of this exemption could create difficulties, the Government thought that it was not appropriate to try to define those who qualified as professionals. Instead, the Government preferred laying on an investment business a duty of care to distribute the relevant information only to persons who appeared to the business to have the requisite understanding and resources. This is to be known as the "know your customer rule" [132].

8.6. Enforcement

The boards and the SROs will be responsible for enforcing their own rules, and the DTI and prosecution authorities for enforcing criminal law [133]. As recommended by Gower, civil law remedies such as disgorgement orders will be introduced. The principal sanction which could be imposed by the board will be the revocation of the authority to carry on investment business. The carrying on of such business without authority will be a breach of the criminal law [134]. The White Paper also recognizes that co-operation between the various bodies and the pooling of information will be essential for effective enforcement [135].

8.7 Ancillary matters

The White Paper adopts many of Professor Gower's suggestions including those on the retention and scope of the deceptive inducement and circularisation offences [136], clarifying gaming contracts [137], cold-calling and cooling-off periods [138], amendments to company law, and the standardization and contents of prospectus and public offer requirements [139]. In some cases the detail of these is left to the boards and SROs to define, whereas in other cases the new Act will do so [140]. Insider dealing provisions will be extended to cover all investments [141]. The White Paper, however, accepts neither the
proposals about pre-vetting public offers [142] nor those about the granting and revocation of permissions to issue [143]. The White Paper also invited suggestions as to whether or not statutory backing should be given to the Panel [144].

9. Some final comments

There remain, even following the White Paper, many features of the new system still to be worked out. Will there be one board or two? If there will be two boards and the DTI, how will the problems of co-ordination be overcome? How will the Panel be brought within the system? How many and what kinds of bodies will be recognized as SROs—the existing trade associations or organizations based on their function as originally envisaged by Gower? What do the Government mean when they say in the White Paper “the Government are not convinced that total reliance can be placed on Chinese Walls”? [145] How will the legal and self-regulatory aspects work together? Is effective self-regulation compatible with the requirements of competitive law? Moreover, the final shape of the financial institutions in London and the nature of the market in which they will be expected to operate still remain unclear.

It seems likely therefore that the plans will need to be refined and updated before the new regulatory edifice can be put into place, but two things seem relatively certain not to change: self-regulation—despite the number of times the word appears in the White Paper—has given way to the statutory regulation. In return for statutory backing, the boards and SROs will have ceded the right to the DTI to require rule changes and amendments to their constitutions. Secondly, the cost of the system will fall, ultimately, upon those buying and selling investments and investment advice.

With hindsight it seems inevitable that, given Government’s policy requirements, the requirements of standardization throughout the EEC, and the City’s disjointed response, the system of self-regulation which has served the mainstream securities industry well in the past would give way to a statutory system. It does seem perverse, however, that the lacunae in the PFI Act and the inefficiency of the DTI in running the statutory licensing system under it, compared with the comparative efficiency and protection offered by the self-regulatory system, should have resulted in the potential abolition of the self-regulatory system and the creation of a statutory one, in which the ultimate power resides with the Secretary of State, but the responsibility and cost fall on the practitioners and users of the system. It does somewhat smack of the Government having its cake and eating it too.
Notes


[2] The main object of both unit trusts and open-ended investment companies is the collective investment of capital provided by the public in a portfolio of securities, thereby spreading the risk of investment. The differ, however, in that in a unit trust the members of the public who participate are beneficiaries under a trust. Each beneficiary does not have any interest in particular assets held by the trust. Instead, all beneficiaries have a collective beneficial ownership of the assets in the trust fund, together with a right, as against the trustees, to receive a repayment of moneys equivalent to the portion of the trust fund attributable to his interest.

In contrast, an investment company (IC) is not a trust at all, but rather a limited company with a share capital formed for the purpose of holding securities or other property by way of investment. The shareholders have a direct interest in the shares of IC but no direct legal or beneficial interest in its assets (i.e., the underlying property or securities). An IC is described as “open ended” when it is formed in a jurisdiction which permits the redemption and issue of share capital at the instigation of the manager. It thus has no fixed maximum issued capital and is “open ended”.


[6] The main professional bodies covering those in the field are The Stock Exchange which covers stockbrokers, the Accepting Houses Committee which covers the top merchant banks, the National Association of Dealers and Investment Managers, the Association of Investment Trust Companies, and the Unit Trust Association.


[11] The offering of facilities for “margin” transactions involved a scheme whereby a victim was persuaded to speculate in shares and deposit cash, or his own securities, with a dealer of security for the “margin”. The victim would believe that his deposit would be returned to him, except insofar as is necessary to pay any losses or expenses when the transaction had been “closed”. In fact the dealer neither bought nor intended to buy shares. He simple operated an account which showed at first a profit so as to induce the victim to increase the extent of his dealing and to put up more security, and which ultimately showed enough loss to extinguish the whole of the “margin” and forfeit the security. Bodkin Committee Report, Cmd. No. 5539 (1936).


[15] PFI Act, 1958, § 2; PFI Act, 1939, § 2. The DTI can declare someone an exempted dealer if the person carries on as his main business, some business other than that of dealing in securities,

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or the dealing in securities amounts to the issue of a prospectus, an underwriting, the making of an offer for sale, the inviting of subscription for government securities, or dealing with a “professional” (which is defined as “a person whose business involves the acquisition and disposal, or the holding, of securities”). *Id.*

[16] Throughout the rest of the article “exempted dealer” refers both to those exempted by the DTI and those whose activities are excepted from the scope of the PFI Act.


[21] 1939 Rules, 1939 STAT. R.&O. 2758, Part I, Rule 3. “Cold-calling” refers to the making of uninvited telephone calls or visits to a prospective investor in order to persuade him to enter a transaction.


[28] *Id.* at § 910–1.

[29] *Id.*

[30] Specifically, the CSI has published the Code of Conduct for Dealers in Securities (1980), Guidelines for Personal Dealings by Fund Managers (1981), and the Rules Governing Substantial Acquisitions of Shares (1981). These latter rules are designed to curb “dawn raids”, which are purchasing operations carried out (historically at the opening of business) on The Stock Exchange for a significant percentage (14.9%) of a company's shares.


[32] *Id.* at 14–16.

[33] *Id.*

[34] “Authorised unit trusts” are those authorized by the Department of Trade if the “unit trust scheme” fulfils certain conditions. According to Professor Gower, the most important of these conditions is that both the managers and the trustees are corporate bodies, incorporated under the law of some part of the United Kingdom or any other state of the EEC and that the trustee fulfils certain conditions specified in the First Schedule to the satisfaction of the Department.

For more detail, *see* Gower Report, *supra* note 4, at 85.

[35] *Id.*


[41] *Id.* at 4.

[42] *Id.*

[43] European Community directive for admission, 79/279/EEC, dealt with coordinating the conditions for admission of securities to official stock exchange listing.

The Listing Particular Directive no. 80/390/EEC dealt with coordinating requirements for the drawing up, scrutinizing, and distribution of the listing particulars to be published for the admission of securities to official stock exchange listing.

The Iterim Reports directive, no. 82/121/EEC concerned information to be published on a regular basis by companies, the shares of which have been admitted to official stock exchange listing.

[45] Under the PFI Act a unit trust can only be “authorized” if it invests in securities and it is an offense to distribute a circular relating to an unauthorized fund. Because of this, those wishing to market a vehicle which could invest in commodities, financial futures, or land had formed open-ended companies in an “off-shore” center which permitted such a form of company. The shares in such companies (which were “securities” within the PFI Act) were then marketed by exempted and licensed dealers and a listing on The Stock Exchange was obtained to avoid the necessity of filing a prospectus for each new issue of shares.

[46] In 1973 the Scott Committee’s Report on property bonds and equity-linked life assurance had recommended that linked life insurance policies should be regulated as insurance rather than investment business. Property Bonds and Equity Linked Life Assurance Committee, Cmd. No. 5281 (1953). As a result of their recommendations, the Insurance Comanies Act 1974 specifically excluded all contracts of insurance from the scope of the PFI Act. The result was that those who market life assurance may “sell” investments in unauthorized unit trusts free from any prohibition under the PFI Act.

[47] At the time of the Discussion Document an issue of securities by a company listed on the Stock Exchange had to comply with the prospectus provisions of the Companies Act 1948 and the Stock Exchange’s own listing requirements and the prospectus would be “pre-vetted” by The Stock Exchange. In other words, the prospectus would be checked by The Stock Exchange prior to being published to ensure it complies with the provisions cited. This contrasts with other issues such as: an unlisted company’s issue of a prospectus, where the provisions of the Companies Act 1948 alone have to be complied with and where the Registrar of Companies does not pre- or post-vet the prospectus; secondary distributions of shares, which are governed by the PFI Act rather than the Companies Act prospectus provisions; and the issue of a share exchange take-over offer, which is regulated by the PFI Act and the City Code, and where applicable, The Stock Exchange regulations rather than the Companies Act prospectus provisions.


[49] Id. at 89.

[50] Id. at 91.


[53] The private companies covered are those which had some kind of public involvement in the ten years prior to the announcement of an offer for them. The type of public involvement involves companies (a) whose shares have been listed on The Stock Exchange; (b) where dealings in its shares have been advertised in a newspaper on a regular basis for a continuous period of six months; (c) whose shares have been traded on the Unlisted Securities Market; or (d) where a prospectus for the issue of equity shares was filed at the Companies Registry.

Note that the Panel has the flexibility to exempt companies which meet the above requirements in cases where the provisions of the Code may not be appropriate. City Code—Introduction page A3 at para. 3.

[54] PFI Act 1958, § 14(2), permission to distribute documents; General Permission No. 3 effective June 1, 1983.

[55] For numbers of directives see supra note 43.


[57] The Restrictive Trade Practices Act 1976 renders void any restriction of a type cited in the Act contained in any agreement of a type cited in the Act and found by the Restrictive Practices Court to be contrary to the public interest. The purpose of the legislation was to proscribe certain anti-competitive practices. Agreements had to be between two or more concerned parties carrying on business in the United Kingdom in the supply of goods. The restrictions included such things as agreements to fix prices, or the terms or conditions subject to which goods are supplied; the
quantity to be produced; and process of manufacture. Later these provisions were extended to agreements relating to the supply of services. Each member of The Stock Exchange performed services in the United Kingdom and The Stock Exchange Rule Book was considered to amount to an agreement among them all which contained potentially anti-competitive practices.

[58] A stockbroker acts as agent for his client and buys and sells securities on behalf of the client. A jobber is not allowed to deal directly with the general public but only with brokers or other jobbers. Jobbers operate in partnerships or companies and specialize in the securities of certain companies. There is usually more than one jobber in the shares of the larger listed companies, although there can be only one in those of smaller listed companies. This division of capacity between broker and jobber depends on the support of all involved for its survival and is expected to disappear once fixed commissions are abolished and brokers are working on the basis of negotiated commissions. It is argued that, in order to offer securities at competitive prices, brokers will find it necessary to take positions in the securities so that they can buy and sell themselves.

[59] "Match" business: to find a buyer and a seller of roughly equivalent amounts.

[60] The "put-through" concept arose from the rules on separation of capacity which require stock to be bought from a jobber. Where a match can be arranged the jobber is given a "turn", say one-eighth of 1%, to put the stock onto his books from one client and sell it off his books to the other. This is called "putting the stock through the market".

[61] The changes will lead to fewer firms of stockbrokers because fixed commissions protected stockbrokers at the expense of investors with a fixed rate for doing business and, therefore, there was no competition on price. The abolition of fixed commissions would lead to significant competition and, possibly, some initial loss-leading by the bigger firms. This could result in a number of medium-sized firms with neither specialist niches nor private client business, nor the capital backing to enable them to buy and sell substantial quantities of securities finding trading conditions difficult, if not impossible.

[62] Under the old rules, dealings on The London Stock Exchange could only be conducted by member firms. Membership could only be obtained after an "examination" had been passed. Overt or covert discrimination resulted in the situation where only U.K. residents were members, and non-U.K. residents could only own a certain percentage of a member firm.

This rule has now been relaxed and non-U.K. residents may own up to 29.9% of a member firm and it is predicted that this will increase to 100%. This has already, and will continue to result in increasing foreign ownership as foreign, particularly North American, organizations take advantage of this opportunity to gain access to London's financial markets. Stockbroking firms in the United Kingdom act as agents for their clients and are usually partnerships that do not have a great deal of their own capital. Part of the reason the British Government supported the Office of Fair Trading's case for the abolition of restrictions from member firms was that it wanted to maintain London's viability as a financial market and considered that this would be impossible without the injection of capital.


[64] "The City" includes members of the Stock Exchange, merchant and clearing banks, and insurance companies which together operate in London's financial market and which are all based around the Stock Exchange in the part of London known historically as "The City". Many of the bodies representing City institutions published their own responses to the document, most of which were hostile to Gower's conclusions. The main concerns of the self-regulatory bodies, such as The Stock Exchange, have been the principle of governmental control and the ability to interfere in their affairs. There was a general feeling that the main institutions—the members of The Stock Exchange and the merchant banks—had provided effective investor protection themselves for some years. It was the "fringe" which had caused such problems as there had been and it had not proved possible in the past to find an effective organization to monitor them. They believed that whilst there may be merit in updating the prospectus provisions of the Companies Acts, extending the
scope of the PFI Act to cover a wider range of investments and licensing investment managers and consultants, and whilst the 1960 Rules needed to be updated to ensure separation of clients' funds and proper disclosure of conflict of interest, etc., there was no need for a wholesale revision of the way securities had been issued and marketing for many years.


[66] Id. at 7.

[67] Some firms would prefer to be registered directly with the DTI because the nature of their business would put them into competition with the appropriate SRA. Harvard Securities, for example, is making a market in shares and, as such competes with The Stock Exchange. The Stock Exchange was thought to be likely to form one SRA and Harvard Securities would have been unlikely to submit to its direction. Furthermore, if an SRA had been formed by the issuing houses, they would have been unlikely to allow certain of the licensed dealers to become members and it would have been easier for them to register directly with the DTI. Gower Report, supra note 4, at 10.

[68] Investors would bear the expense of day-to-day regulation, thereby helping to achieve the government's goal of reducing manpower and cutting costs. Note that Gower envisaged the CSI, with an expanded staff, coordinating the activities of the SRAs.

[69] “Investment business” would be defined so as to cover all those professionally engaged in the marketing of investments. This would cover those who manage investments, those who advise, financial journalists, and people circulating “tip sheets.” It would not, however, include bona fide investment clubs, though it would include a professional manager of the club's investments.

[70] Throughout the rest of this article “governmental agency” refers to the body envisaged by Gower as either a self-standing commission or the DTI.

[71] Rules relating to admission to membership should ensure that those who undertake investment business are fit and proper persons as evidenced by their character, training and experience, and financial resources. The IPA should empower the governmental agency to prohibit any registered firm from employing anyone who is found guilty of an offense involving fraud or who committed a breach of the IPA. Gower also suggests that the governmental agency should maintain a comprehensive computerized register of those entitled to undertake investment business. Firms in foreign countries could be registered if their country had comparable regulations and afforded U.K. firms reciprocal rights. The IPA should also give the governmental agency the power to suspend, not only revoke, registration in appropriate cases.


[73] In ¶ 4.04 of the Report, Gower gives an example of arrangements for betting on whether the quoted price of a listed stock or an index will rise or fall, which would seem akin to gaming and wagering contracts and therefore unenforceable. He goes on to say, however, that the objectives of the participants may be indistinguishable from those who purchase options or futures. The present law is so unclear on this that the founders of the London International Financial Futures Exchange were concerned that some of its contracts might be regarded as gaming and wagering contracts. Id. at 27.

[74] Id. at 37.

[75] A cooling-off period is the time, after a decision to invest has been made, in which the investor is entitled to cancel the investment. Id. at 117.

[76] The prospectus provisions should also apply to secondary issues even where the issuer is not the company or an officer and therefore it may not be possible for him to obtain up-to-date information from the company.

[77] Compulsory acquisition refers to a power to acquire the shares of shareholders who dissent from a scheme or contract approved by a nine-tenths majority, that involves a transfer of shares to another company. Companies Act, 1948, § 209.


[79] “Circulars” would include communications, beyond just written, and a series of communications containing similar information. Professor Gower, however, does not think it is practical to prohibit oral solicitations other than by placing restrictions on cold-calling.
[80] PFI Act, §§ 13 and 14.
[81] Under present law, a publisher is not liable for publishing an investment advertisement.
[83] The magistrate's court is the lowest tier of the criminal courts.
[84] Gower Report, supra note 4, at 188.
[85] Id.
[88] See supra text accompanying notes 73–83.
[90] Id. at 13–16.
[91] Id. at 6.
[92] Id. at 8–12.
[93] Id. at 7.
[94] Id. at 6.
[95] Id.
[96] Id.
[97] Id.
[98] Id.
[99] See supra text accompanying note 50.
[100] See supra text accompanying notes 55, 56.
[101] See supra text at section 4.3.
[103] Id. at 16.
[104] Id. at 13.
[105] See supra text accompanying note 50.
[107] Id.
[108] Id. at 15.
[109] Id. at 13.
[110] Id. at 8.
[111] Id. at 8–9.
[112] Id. at 9.
[113] Id. at 28.
[114] Id. at 14–15.
[115] Id. at 14.
[116] Id. at 14–15.
[119] Id.
[120] Id. at 19–22.
[121] Id. at 20.
[122] Id.
[123] Id.
[124] Id.
[125] Id.
[126] Id. at 28.
[127] Id.
[128] See supra text accompanying notes 31–33.
[130] Id. at 27.
G.F. Pimlott / Investor protection in the U.K.

[131] Id.
[132] Id. at 21.
[133] Id. at 39.
[134] Id. at 40.
[135] Id.
[136] Id. at 33.
[137] Id. at 11.
[138] Id. at 33.
[139] Id. at 35.
[140] Id. at 14.
[141] Id. at 37.
[142] Id. at 36.
[143] Id.
[144] Id. at 36.
[145] Id. at 20.

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