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The Financial Services Act: A Case Study in Regulatory Capture

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Abstract

This thesis explores, in a case study, the interests served by the UK Financial Services Act of 1986. The Act put in place a revolutionary new regulatory framework for controlling the sale of investment products such as pensions and insurance. The stated objectives of the new regime were to protect the ordinary investor, 'Aunt Agatha', from mis-selling and bad advice. However, there is casual evidence to suggest that the regime has failed in this objective. Moreover, there exists, in public choice theory, an explanation for why regulation might fail in this way. The study investigates whether regulation did fail to achieve its official objectives, and if it did, what were the reasons for this failure? Does public choice provide an explanation for the failure of the FSA?

The study explores the interests served by the FSA. Specifically, it contributes to knowledge on three fronts: (i) related to the application of a sophisticated public choice analytical framework to a case study of British government regulation; (ii) related to the comparing of the practical adequacy of the public interest and public choice theories of regulation; and (iii) related to the case study itself, which develops a greater understanding of the origins, development, effects, and interests served by the FSA.

The thesis concludes that the regulators, in large part, failed to enforce the rules and moreover that the cause of this failure, as public choice theory suggests, was the influence of the industry. In short, the thesis finds that the regulators were captured by the industry.

Dedication

This thesis is dedicated to my parents and family and to my eternal soul mate, Yuan Min.

Acknowledgements

I would like to acknowledge a huge debt of gratitude to Professor Kevin Dowd. Kevin has shown, at all times, immense patience, and has been a never-ending source of wisdom, guidance and friendship.

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Finally, I thank my family, my friends, and my fiancée, Min, for their encouragement, support and patience.

List of Abbreviations

ABI	The Association of British Insurers
DGFT	The Director General of Fair Trading
FIMBRA	The Financial Intermediaries, Managers and Brokers Regulatory Association
FSA	The Financial Services Act
FSMB	The Financial Services and Markets Bill
IFA	Independent Financial Adviser
LAUTRO	The Life Assurance and Unit Trust Regulatory Organization
OFT	The Office of Fair Trading
MIBOC	The Marketing and Investment Board Organizing Committee
PIA	The Personal Investment Authority
SIB	The Securities and Investment Board
SIBRO	The Securities and Investment Board Regulatory Organization

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CHAPTER ONE

Introduction

"Is there a greater tragedy imaginable than that in our endeavour consciously to shape our future in accordance with high ideals we should in fact unwittingly produce the very opposite of what we have been striving for." Friedrich. A. Hayek.

1. Introduction

The perspicacious quote cited above from Hayek is a fitting prelude to a thesis that investigates the interests served, and the effectiveness, of a prime example of so-called consumer protection regulation. As many public choice scholars have often claimed, regulatory initiatives have had pernicious effects despite the best of intentions. Regulation has often harmed the very people that it was ostensibly supposed to benefit. An equally fitting quote would be '*Quis custodiet ipsos custodes*'; who will guard the guardians? For whilst regulatory agencies can be established with the official task of implementing rules, by what means can the regulators be effectively held to account? What barriers are there to the regulators being captured by the very people they are supposed to regulate?

These and other issues are explored in this study which constitutes a comprehensive investigation of the effects of, and interests served by the Financial Services Act 1986 (FSA). I consider the Act in the context of the public interest and the public choice theories of regulation. The public interest theory asserts that regulation will serve the wider public interest whilst the public choice theory contends that regulation often serves narrow private interests. I examine the validity of both sides to this theoretical polemic in the context of a major example of British financial regulation.

In this introductory chapter, I shall endeavour to introduce the study and to present a road map for the thesis.

2. The Background to the Study

I would hope that this study is of interest not only to policy-analysts and to academics, but also to a more general audience. There are a number of reasons why it might be: (i) the importance of the investment business sector to the UK economy makes its regulation, and more importantly, the study of its regulation, a subject of major interest to the public policy analyst; (ii) there is significant controversy over the effectiveness with which the FSA has protected the investor and over the interests served by the FSA; (iii) the controversy over the interests served by the FSA combines with a hefty literature which condemns the public interest view of regulation as being fatuous.

The study thus constitutes an analysis of a major and controversial example of regulation, against a background of general empirical and theoretical controversy over the interests served by government regulation generally. In addition, the study comes at a time of great media interest in the regulation of investment business. This is due in part to the many scandals that have beset the industry over the preceding decade, and in part to the new Financial Services and Markets Bill, which is currently passing through Parliament, which proposes to reform the regulatory regime for investment business.

The Financial Services Industry

The financial services industry is of profound importance to the UK economy. It accounts for seven percent of GDP and employs well over a million people in the City of London and throughout the country. The financial services industry is also a major contributor to the invisible account of the balance of payments, with insurance alone earning over £3 billion in service exports in 1997. The industry has grown rapidly over the last twenty years; the assets of the life and pensions institutions saw growth of over 100% over the seven years between 1992 and 1999[1]. Life assurance and pensions have taken an increasingly important share of personal sector savings, now accounting for over 50%. Consumer expenditure on pensions and savings increased from £27 billion in 1988 to some £70 billion in 1998, an increase of 160% in nominal terms. Some 75% of households in the UK have bought financial services and by one estimate, there are 30,000 different financial services products on the market for them to choose from. The total combined assets of the life, pensions, unit and investment trust companies amounts to over 1.4 trillion pounds.

The financial services industry of the early 1970s was very different to that of the 1990's. The industry was sharply differentiated with each sector providing a

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[1] The Office for National Statistics. (October 1999), Financial Statistics.

narrow range of products to their customer bases. There was relatively little competition between sectors due to structural regulation, and there was little genuine competition within sectors as anti-competitive self-regulatory cartels prevailed. The banks provided a relatively narrow range of banking services, including primarily current accounts[2] and savings accounts.[3] The insurance companies provided insurance services[4] and the building societies provided mortgage loans, and savings accounts. Each sector had its own unique cultural identity and the gulf between a merchant bank and a home service insurance office or insurance broker was enormous. Power in the financial services industry rested firmly with the stock exchange, the merchant banks and the old stock broking firms. Managers tended to be from similar social backgrounds and the Bank of England played a pivotal role as supervisor and overseer of the financial system and defender and lobbyist for the industry in Whitehall.

The period from 1970 to the present day has seen a quite remarkable metamorphosis in the financial service industry. The structure of the markets, the range and complexity of the products, and the power, size and importance of the providers have all changed dramatically.

The Controversy over the Effects and Interests Served by the FSA

On the 7 November 1986, the Financial Services Act (FSA) received its Royal Assent. This Act was to usher in a new, dynamic regulatory regime which would protect the investor, ensure the long term prosperity of London as a major world financial centre and put an end to a succession of scandals and collapses which had [supposedly] tarnished the image of the industry for years. The regulatory framework had been inadequate, inconsistent, inappropriate and, clearly, allowed those intent on fraud or exploitation to get through the net. The new Act would mean that Aunt Agatha would finally be able to go to someone who was "...honest, competent and solvent."[5]

[2] However, accounts came with no cheque guarantee cards, no credit cards, and no interest on deposits.
[3] With relatively low levels of interest compared to building societies.
[4] Home service companies dominated the market.
[5] Betty Powell, SIB Press Secretary, commenting in 1988 on what the new Financial Services Act (FSA) would mean for the private investor.

Despite the myriad of apparently cast-iron assurances that accompanied the passing of the FSA[6], there is considerable casual evidence[7] that the FSA has not succeeded in its supposed objective of protecting the investor (Large 1993, Llewellyn 1994, 1995, 1996; Goodhart 1992, 1995; Gower 1995; Ross 1986; Simpson 1996). Moreover, many have argued that the overall costs of regulation have outweighed the benefits[8]. Criticism of the regulatory regime created by the FSA has been pervasive over the last decade. Even before the Act was fully implemented in February 1988, the Institute of Economic Affairs (IEA) published a severely critical book entitled "Financial Regulation - or Over-Regulation?"[9]. In this book, among others, the esteemed economist and subsequently member of the Bank of England's Monetary Policy Committee, Professor Goodhart criticised the FSA as going beyond what was necessary for investor protection and argued that the costs of regulation would be substantial. Others have criticized the regime, for the enormity of the costs imposed, others have targeted the regime for being excessively bureaucratic, prescriptive and cumbersome, and others still have been critical of the lax enforcement of the regime. Most however have berated the regime for its apparent failure to protect the investor, to prevent scandals and to deliver the protection that was promised.

The study is thus located within an arena of great controversy; the FSA, now in the process of being replaced by the fully statutory FSMB, is an act which many believe has failed utterly to protect investors.

The Controversy of the Effects of, and Interests Served by Regulation

The controversy over the interests served by the FSA is symptomatic of an apparently wider and ubiquitous phenomenon evidenced in a plethora of studies of regulation principally from America. These studies have sought to investigate the interests served by government regulation in a range of different fields and industries. This literature on regulation has added weight to an alternative theory of regulation to that propounded by public interest theorists; namely one which rejects the notion that regulation serves the public interest and asserts that regulation often appears to serve

[6] Which stated amongst other things that the investor would be protecting from mis-selling and fraud.
[7] Offered some substantiation by the major overhaul of the FSA announced by Mr Brown.
[8] Although notoriously difficult to assess, the extent of the costs of regulation coupled with the apparent failure of regulation to prevent scandal, suggests that the benefits may not outweigh the costs of regulation.

private interests. These studies have almost overwhelmingly established that regulation, as a rule, is acquired by an industry and is designed and operated primarily for its benefit.[10]

My research thus contributes to a sizeable literature, which seeks to unveil the interests served by government economic regulation.

The Reform of Investment Business Regulation

On the 20 May 1997, the new Chancellor of the Exchequer, Mr Gordon Brown, announced that he planned a major overhaul of City regulation, with the structures created by the Financial Services Act 1986 (FSA) being replaced by a single, all-encompassing[11] fully statutory regulatory body (called the Financial Services Authority). When, Mr Brown announced his plans, he triumphantly exclaimed that the new body would *"put the public interest first."*[12] Where had we heard that before? In fact, we had heard it ten years earlier. This study of the first attempt to 'put the public interest first' will thus shed light on the way in which New Labour is going about its reforming task.

3. The Objectives of the Study

This thesis seeks to explore and unravel the complex coalition of private interests and the machinations of politicians and the industry elite, which led to the revolution in regulation, which eventually became the FSA. The main objectives are to:

1. Apply a public choice analytical framework to a case study of British government regulation.

2. Compare the practical adequacy of the public interest and public choice theories of regulation.

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[9] Seldon, A. ed. (1988) *Financial Regulation - or Over-Regulation?,* (London: Institute of Economic Affairs).
[10] Stigler, G. (1971) "The Theory of Economic Regulation", *Bell Journal of Economics and Management Science*, Spring.
[11] The new regulatory authority, called The Financial Services Authority would be responsible for banking as well as financial services regulation.
[12] Gordon Brown, Chancellor's Statement to the House of Commons on the Bank of England, *HM Treasury News Release*, 20 May, 1997.

3. Develop a greater understanding of the origins, development, effects, and interests served by the FSA.

The following chapter (chapter two) considers the theoretical literature (within economics) on the interests served by government regulation. This theoretical chapter informs the research approach articulated in chapter three; which considers the philosophical basis of the research and the methodology to use. Chapter four explores the origins of the FSA from the commissioning of Professor Gower to report on the regulation of investment business, to the passage of the Bill through Parliament in 1985-1986. Chapter five focuses on the development of the FSA regime and its capture. Chapter six explores the record of the FSA in terms of the enforcement of rules and in terms of its effectiveness in achieving its objectives. Finally, chapter seven explores whether the FSA has had negative side effects on the investor and on the investment industry. Finally, the main conclusions are presented in chapter eight, along with some proposals for future research.

CHAPTER TWO

Economic Theories of Government Regulation

1. Introduction

This chapter explores the economic theories of regulation. However, it would seem apposite to commence the chapter by considering exactly what is meant by the construct 'regulation'. Dictionaries offer a number of definitions of the term:

"To regulate (1) control by rule; (2) subject to restrictions; (3) adapt to requirements." From the Latin *regula* RULE;

"Regulation (1) the act or an instance of regulating; the process of being regulated. (2) A prescribed rule; an authoritative direction."[13]

The quotes listed above present a very broad definition of regulation. Indeed, strictly speaking, one could say that any specification by the state of the structure of property rights is 'regulation'. However, both of the definitions set out above are too broad for the purposes of this study. Instead, regulation will be conceived here in terms of the activities of the State which are explicitly directed – supposedly – to achieve pre-determined political or economic objectives. Regulation is thus "...a means by which the Government seeks to influence decision-makers in the economy in the pursuit of specified objectives."[14]

The utilization of the coercive regulatory powers of the ruler to regulate and control the activities of commerce and of individuals within society has been a common phenomenon throughout history.[15] However, the sheer scale of the regulatory intervention of the democratic state into the realm of economic activity now witnessed is a relatively novel development. From relatively modest beginnings at the beginning of the century, State regulation of commerce has grown rapidly in

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[13] Oxford Concise Dictionary. (1996), p. 1158.

[14] Bannock, G. and Professor Sir Alan Peacock (1995) "The Rationale of Financial Services Regulation: Is the Current Structure Cost-Effective and Working?" *Discussion Document* funded by IFA Promotion and published by Graham Bannock and Partners Ltd. p.13.

[15] Regulation by the ruler began in the Garden of Eden when God (this is not an acronym for a regulatory agency but a supposed supreme being) decreed that Adam and Eve were not permitted to

Britain and America. In America the growth has been particularly voracious. As Friedman states The Federal Register, established in 1936 to record all regulations, hearings and other matters concerned with regulatory agencies grew rapidly.

> Three volumes, containing 2,599 pages and taking six inches of shelf space, sufficed in 1936; twelve volumes, containing 10,528 pages and taking twenty-six inches of self space, for 1956; and thirteen volumes, containing 16,850 pages and taking thirty-six inches of shelf space, for 1966[16]

In Britain, the growth in the regulatory activity of the State has been less rapid than in America, but has been nonetheless dramatic. Focusing merely on so-called competition regulation, a raft of substantial Acts of Parliament can be identified, including,

- The 1948 Monopolies and Restrictive Practices Act
- The 1956 Restrictive Practices Act
- The 1964 Resale Prices Act
- The 1965 Monopolies and Mergers Act
- The 1973 Fair Trading Act (created the Office of Fair Trading)
- The 1980 Competition Act

In addition to the creation of these regulatory instruments, two regulatory agencies were created and imbued with statutory powers of investigation, enforcement and prosecution. These were:

- The Office of Fair Trading (OFT).
- The Monopolies and Mergers Commission (MMC).

In the realm of financial services, the last twenty years have witnessed an astonishing increase in regulatory intervention. Among the many statutes relating to financial services passed in this period, the following are some examples:

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eat from the Tree of Knowledge. The penalty for non-compliance with this rule was considerable and perhaps beyond the realm of natural justice.

[16] Friedman, (1983) *Free to Choose* (Penguin books), p.228.

- The Banking Act 1979, 1987
- The Insurance Brokers (Registration) Act 1977
- The Insurance Companies Act 1982
- The Financial Services Act 1986
- The Building Societies Act 1986

In the field of company law, the growth in the volume of regulation has been particularly significant. As Campbell states "The most striking feature of English company law since 1979 is its volume: there have been four major Companies Acts (the last one of which was 216 sections and 24 schedules), at least seven very substantial related Acts and more secondary legislation than one can clearly identify".[17]

The 1980s and 1990s witnessed a whole raft of other increasingly interventionist regulations. This contrasts markedly with the oft repeated, but misleading contention that policy of the period was predominantly de-regulatory[18]. Among the new regulatory initiatives were ones related to:

- **Food Safety.**

In 1990 there was the Food Safety Act which spawned the Food Hygiene (Amendment) Regulations of 1990 and 1991, the Fresh Meat (Hygiene and Inspection) Regulations 1992, Regulations of 1992 implementing EEC Directive 91/497 and the Fisheries Products Regulations which implemented EEC Directive 91/493.[19]

- **The Environment.**

The Environmental Protection Act of 1990 spawned a raft of secondary legislation including the Waste Management Regulations 1991, and Environmental Protection (Prescribed Processes and Substance) Regulations 1991. These regulations

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[17] Campbell, D. (1997), "The Role of Monitoring and Morality in Company Law: A Criticism of the Direction of Present Regulation", 7, *Australian Journal of Corporate Law*, 343-65, p.343.

[18] Although it is the case that particularly the legislation related to the Building Societies was predominantly deregulatory in character.

implemented a raft of EEC Directives including Directives 84/360 on industrial air pollution, 91/156 on waste disposal and 91/157 on the collection and recycling of batteries.

- **Consumer Protection**

In the realm of consumer protection the last twenty years have seen the Consumer Protection Act 1987, the Financial Services Act 1986, the Furniture and Furnishings (Fire) (Safety) (Amendment) Regulation 1988, the Toy Safety Regulations 1989, the Weighing Machines (Non Automatic Weighing Machines) Regulations 1988, the Food Limitations (Safety) Regulations 1989 and the Price Marking Regulations 1991.[20]

The picture outlined above is of ever increasing regulatory intervention. As Eggertson states, "in the past 100 years or so, Western governments have increasingly restricted the property rights of owners of inputs, particularly nonlabor inputs, and increased the role of the state in economic activity."[21] An almost inevitable corollary of this increased regulatory activity of the state, is that a literature has burgeoned attempting to evaluate, explain and understand these regulatory activities. From this literature emerge two general economic theories of government regulation. Each of the theories claims to explain the origins, effects and interests served by regulation. The first theory is the *public interest* theory.

The normative public interest theory, formalized by welfare economists such as Pigou (1920) at the beginning of the century, provides a theoretical justification for the use of government regulation to pursue specified public interest objectives. The

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[19] Between 1991 and 1993 Environmental Health Offices increased the number of annual inspections from 150,000 to 419,000 (Booker, 1995, p.28).

[20] To be added to the above list are the array of food safety regulations provoked by the BSE/ CJD 'crisis' in 1995-1997. On the basis of little scientific evidence, but in the face of a huge public panic stirred up by the media, regulations were passed requiring the destruction of all cattle in BSE infected herds at a huge cost to the taxpayer who was forced to compensate the farmers for their losses. Meanwhile, prompted by German national self-interest, the EU evoked a ban on British beef in Europe. Most seriously, the crisis provoked a significant ratcheting up of food safety standards, especially in relation to abattoirs. The results of these regulations were that thousands of abattoirs were plunged into insolvency. The epilogue to the BSE 'crisis' was the banning of beef-on-the-bone in 1997. Despite being a lesser risk than that of winning the jackpot in the National Lottery[20], the Government responded to media panic on the possibility that CJD could be caught from eating meat cooked on the bone by banning all sales of this form of beef, and indeed, at least one restaurant owner was prosecuted for breaching this prohibition.

[21] Eggertson, T. (1997) *Economic Behavior and Institutions,* (Cambridge University Press), p.143.

public interest theory explains what regulation *should* do. It presumes that impartial and altruistic public servants can implement government designed regulatory programmes to correct market failures in a virtually costless manner.

The second theory is the public choice theory. This theory, which has spurned a very sizeable literature, developed largely in response to the apparent failure of the public interest theory as an explanation for the empirical effects of government regulation. This theory offers an alternative explanatory framework for state regulation. An important feature of the public choice theory[22] is that it abandons the notion that regulation is a mechanism for pursuance of the public interest, and replaces it with the notion that regulation is a mechanism by which small minority interest groups seek privileges. The public choice approach replaces the idealism of the public interest theory with the rational, utility-maximimizing self-interest paradigm of neo-classical economics. Private interests, most often well organized business interests, it is argued, often originate regulation and, more importantly, regulation invariably operates so as to benefit them at the expense of unorganized groups (e.g., such as consumers).

This chapter considers both theories of regulation and critically examines the empirical literature.

2. The Public Interest Theory of Regulation

The phenomenal growth in the regulatory activity of the State has been rationalized by the economic theory of welfare economists such as A.C. Pigou (1920), W. Baumol (1956), Francis Bator (1988) and W. Pareto (1971). Levine and Forrence (1990) crystallize the approach,

> We can see regulation as the necessary exercise of collective power through government in order to cure "market failures", to protect the public from such evils as monopoly behavior, "destructive" competition, the abuse of private economic power, or the effects of externalities.[23]

[22] The public choice theory is also often referred to as the private interest theory.
[23] Levine, M.E. and Forrence, J.L. (1990) "Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis", *Journal or Law, Economics and organization*, Vol. 6, Special Issue.

Although there exist a very extensive range of public interest explanations for the regulatory intervention of the state, ranging from the Marxist to the neo-liberal, in the economics literature, the most common is centred upon a market failure based approach. This approach takes as its starting point the ideal neo-classical concept of general competitive equilibrium. Arrow and Debreu (1956) successfully demonstrated that under certain strong assumptions about consumer and firm behaviour and about market conditions, the price mechanism would lead the economy to a state of general competitive equilibrium through the invisible hand of the market.

Given the assumptions adopted, Arrow and Debreu demonstrated this outcome would be Pareto efficient. A Pareto optimal outcome is one where any change would not increase any individual's utility without diminishing that of another. This is the 'first' or 'basic' theorem of welfare economics, at this point there will be a socially efficient allocation of resources (marginal social cost is equal to marginal social benefit). As Campbell states, "It would appear that in its modern form this model is non-defective, so that we must say that general competitive equilibrium *is* the optimal mechanism for the allocation of resources"[24].

However, no empirical market exists which exhibits the conditions of perfect competition (Coase 1988; Campbell 1996).[25] Moreover, in all empirically observed markets, market failure is ubiquitous.[26] Goods and services are rarely homogeneous, barriers to entry and exit must always exist[27], and knowledge is manifest in its imperfections.[28] The recognition that empirical markets do not approximate to the neo-classical state of general competitive equilibrium is hardly a monumental one.[29] However, this recognition *is* significant because of the train of reasoning that it precipitates amongst welfare economists. If markets suffer from imperfections, which prevent general competitive equilibrium from being reached, then they argue that they

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[24] Campbell, D. (1996) "On What is Valuable in Law and Economics", *Otaga Law Review*, vol. 8, No. 4, p.489.

[25] As Campbell states of the requirement for fully contingent markets, "...but, of course, as fully contingent markets can be established only with complete information about the state of the world as it affects all relevant exchanges and complete information about the state of the world as it affects all relevant exchanges and complete transparency in communication of that information, it is the purest form of fiction to imagine that such equilibrium will ever actually occur." (Campbell 1996, p.490).

[26] Indeed markets *must* be imperfect because transactions costs, assumed to be zero in the model, must be positive.

[27] This is because transactions costs are always positive.

[28] Buyers and sellers, given imperfect knowledge will act strategically to exploit the ignorance of the counterparty.

are sub-Pareto optimal and conclude that the public interest is not satisfied. A fortiori, there is a case for regulatory intervention to produce a Pareto improvement and bring about an equilibrium in which the public interest is served.

In the context of financial services a number of potential market failures in the market for retail investment products are typically identified:

- Problems of asymmetric information. These refer to problems caused due to differences in the information possessed by buyers and sellers of financial services. As Goodhart (1994) states, information asymmetries often exist in financial services, as it is essentially the superior knowledge of the agent that the principal is paying for. Information asymmetries, can lead to problems identified by Akerlof (1970). Akerlof suggested that where there is a difficulty of consumers determining the quality of products, the result can be an overall depression of quality as the lower quality products (the 'lemons' as Akerlof called them in his analogy of second-hand cars) drive out the better quality ones. This can ultimately lead to a situation where none of the product is traded at all: in other words the outcome is a complete market failure.

- Under-investment in information by consumers. This is the *free-rider* problem where everyone assumes that others have investigated the safety and integrity of suppliers of financial services and so no one actually does any research.

- Potential principal-agent problems and conflicts of interest whereby there is uncertainty on the part of the principal as to what actions should be undertaken and what actions have been undertaken by the agent.

- Because of the technicalities of some financial products, consumers are not equally equipped with an ability to assess quality etc.[30]

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[29] Although the assumptions of the rational utility maximizing self interested individual (*'homo economicus)'* remain dominant (Becker and Stigler 1974; Posner 1992; Friedman, D. 1984, 1989).
[30] Llewellyn, D.T. (1993) "Reflections on Recent UK Experience of Financial Regulation", September, *Butterworths Journal of International Banking and Financial Law.* p.375.

According to some economists (Llewellyn 1995 and Goodhart 1995) these market failures provide the main case for regulation of the financial services market.

Having deduced a potential case for intervention to correct market failures and improve efficiency, public interest proponents have argued that state regulation can be utilized to correct market failures that would otherwise "...work to the detriment of consumers if market mechanisms were allowed to operate unfettered."[31] Government was compelled to intervene *to safeguard the public interest.*[32] In this sense, regulation was a substitute for competition. Joseph B. Eastman argued that regulation is needed to

> promote order and stability, prevent exploitation, and curb destructive competition and waste. The public served needs it, not only as protection against extortionate charges, but to prevent unjust discriminations, promote safety, reliability, and responsibility of service at known and stable rates, reduce expense both direct and overhead, and avoid a financial demoralization which in the end is as destructive to the public interest as it is to the private investors[33]

Regulation is a "...means whereby public authority endeavors to curb abuses arising from imperfections in the market,"[34] and "since political actors are considered selfless and well informed, the public interest can be readily and accurately divined; since the political process is considered costless, the public interest is easily achieved..."[35]

In the period from the late 19th century up until the 1950s two assumptions were thus dominant in economic thinking. First, that "economic markets are extremely fragile and apt to operate very inefficiently (or inequitably) if left alone," and second that "government regulation is virtually costless."[36]

There are a number of specific ways in which regulation can, arguably be of potential benefit to the consumer in the financial services industry:

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[31] Llewellyn, D.T. (1986) "The Regulation and Supervision of Financial Institutions", *Loughborough University: Institute of Bankers conference*, p. 11.
[32] Wilcox, C. (1966) *Public Policies Towards Business*, (Homewood, Ill.: Richard D. Irwin).
[33] Eastman, Interstate Commerce Commissioner 1933, quoted in Horowitz, R.B. (1989) *The Irony of Regulatory Reform*, (New York: Oxford University Press), p. 26
[34] Pegrum, D. (1965), *The Public Regulation of Business*, (Homewood, Ill.: Richard D. Irwin), p.38.
[35] Mitchell, W.C. and R.T. Simmons (1994) *Beyond Politics: Markets, Welfare, and the Failure of Bureacracy* (USA: The Independent Institute).p.3.
[36] Posner, R.A. (1974) "Theories of Economic Regulation", *Bell Journal of Economics and Management Science, 5,* (Autumn), p.336.

- The correction of identified market imperfections and failures that reduce consumer welfare and distort competitive and market mechanism.

- The provision of a single monitoring agency which can also undertake the role of authorising firms (based on fit and proper criteria) can benefit consumer due to economies of scale.

- Having a regulatory agency to signal minimum quality levels can enhance systemic market confidence.

The assumption that government regulation can be utilised costlessly to correct market failures has, in many respects, shaped economic policy of the late 20th century. The Western economies of the late twentieth century – at least in terms of commerce - are overwhelmingly regulated economies, to an extent that would have been inconceivable to anyone only a hundred years ago. The dramatic growth of regulation, originating both from the national state and increasingly - for Britain - from the European Union, has been rationalized by the public interest view of regulation. Market failures are identified and regulatory instruments are then designed and implemented to correct the failure and improve market efficiency – or so the theory goes. This is the – normative – theory of regulation.

3. A Critique of the Public Interest Theory

Whilst evidence is frequently paraded[37] which attests to a continued faith in the effectiveness of regulation by State bureaucracies, the public interest theory has been the subject of sustained criticism in recent years. The attacks have centred on three main aspects of the theory. First, at a philosophical level doubt has been expressed at whether the construct 'public interest' actually makes any practical sense. Moreover, others (Arrow 1951, Buchanan 1962) have questioned whether, even if the public interest, as a construct is conceptually coherent, it is realizable in practice through existing constitutional mechanisms. Second, the critics of the public interest approach

[37] Evidence of this faith in State regulation can be found in any British newspaper, where the solution advanced for seemingly every societal ill is further regulatory intervention by the State.

have questioned the logic and sense of the economic reasoning inherent in the 'market failure' approach to the legitimization of regulation. They argue that public interest proponents have committed the 'Nirvana Fallacy' by arguing that imperfect free-markets are inferior to the *perfect* state. Finally, critics have challenged the public interest theory on empirical grounds. The alleged failure of the public interest theory as an *explanation* for actual cases of government regulation has been utilized to cast doubt on its veracity as an empirically supported theory of regulation.

The Nirvana Fallacy: Re-Defining Market Failure

The difficulty in defining the 'public interest' as a philosophical or political concept,[38] and the strength of the arguments which suggest that the public interest is at best unknowable and at worst meaningless, has led advocates of regulation to equate the public interest with the concept of economic efficiency or Pareto optimality. This line of reasoning takes on board the arguments of individualist liberals such as Bentham and Smith and argues that the public interest is served when individuals are able to transact in an environment in which the market operates with

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[38] The public interest perspective on regulation is shrouded in the same ideological debate and terminological confusion as the wider conflicts on what the proper role of the state should be. In a political system which is based not upon direct democracy but on representative government, the concept of the 'common good' or 'public interest' becomes crucial, not merely to the state's effectiveness but also to its legitimacy. However, despite the frequent and casual use of the term, the concept of the 'public interest' is nebulous. Debate surrounds whether interests are based purely on subjective individual preferences or 'wants' or whether there are 'real', genuine interests which can be expressed objectively. Social contractarians such as Locke (1690), Hobbes (1655) and especially Rousseau (1762), contend that there *is* a 'general will' which represents the objective collective interests of society. According to Rousseau, the general will is that which the people would wish if they were to act selflessly. In *The Social Contract* he argued that the general 'will', tends always to the preservation and welfare of the whole. From this point of view, the Leviathan state of Hobbes thus has a legitimate role in working to bring about this state. However, this view contrasts sharply with the perspectives of individualist liberals. Individualist liberals such as Smith, Mill and Bentham argue that if interests are unobservable at low cost - other than to the individual - then the notion of a collective 'public' interest becomes incoherent. Individualist liberals argue that there are only *private* interests; namely the interests of individuals. Bentham (1789), for example argues that individuals seek to maximize their private, subjective utility. The only interests are private interests and any conception of a 'public interest' is at best the sum of the interests of those who comprise it. This conception makes little sense, as each individual within the collective will strive for something different. Thus, as Heywood argues "a collection of private interests does not add up to a coherent 'public interest'" (Heywood, 1994, p.187).

In addition to the problems of defining 'public interest', other theorists have argued that even if, in principle a conception of a public interest is possible, there are no methods by which this can be revealed. In the Impossibility Theorem, Arrow (1951) argues that there is no method of aggregating individual utility functions so as to reveal the collective interest. From this, Buchanan and Tullock (1962) and other public choice scholars argue that the impossibility of determining the public choice renders any conception of the public interest to be arbitrary.

as few impediments to the pursuit of rational self-interest as possible. The public interest role of the state is thus to remedy market failures which prevent this individual utility-maximizing behaviour. Economists have thus sought to identity market imperfections (such as information asymmetries or externalities) and then to argue that there is then, *a fortiori*, a case for state intervention. However, by comparing an imperfect market with a perfect regulatory solution such proponents have committed what Demsetz calls the 'Nirvana Fallacy'. As Campbell states,

> After 'The Nature of the Firm', Coase largely worked on a number of empirical studies of governance structures, particularly the state regulation of industry. Whereas the power of his account of the firm lies in the way it shows the market has positive transaction costs, the power of these studies shows that regulation had such costs too, and that simply to advocate regulation because one was dissatisfied with the market was absurd.[39]

Indeed, even Pigou argues that,

> It is not sufficient to contrast the imperfect adjustments of unfettered private enterprise with the best adjustments that economists in their studies can imagine. For we cannot expect any state authority will attain, or will even whole-heartedly seek, that ideal.[40]

However, as Campbell continues,

> Coase was able to make terrific fun of many regulatory initiatives, showing that broadly Pigovian solutions simply were not well enough thought out because Pigou typically failed to inquire into the working of the regulation he advocated but rather worked by assuming the existence of (almost) perfectly functioning public bodies.

A corollary of Coase's contribution is that the identification of market *imperfections,* when empirical markets are compared to an ideal model of the market[41] does not amount to the identification of market *failure*. Market failure can only be said to occur in any meaningful sense when it can be shown that there is an imperfect *state*

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[39] Campbell, I.D. (1996) "What is Valuable in Law and Economics", *Otago Law Review*, Vol. 8, No.4. p. 499.
[40] Pigou, A.C. (1920) *Economics of Welfare*, (London: MacMillan and Co. Ltd.), p.294.
[41] As represented in neo-classical microeconomics.

regulated outcome that would be superior (in the Pareto sense) to the imperfect non-regulated *laissez-faire* outcome.

Economists and policy-makers must therefore satisfy two conditions in order to fulfil the necessary requirements for state intervention to be economically justified. First, they must identify market imperfections. What are the primary reasons why the market 'fails'? In the case of financial services regulation, it is often argued that the existence of information asymmetries between the seller and the buyer of complex financial products means that regulatory intervention is required in order to offer certain guarantees to the consumer about product quality.

However, it is not enough just to identify market 'imperfections'. The real world is imperfect and it is thus inevitable that market imperfections will exist when reality is compared to an abstracted idealized model. The advocates of state intervention must therefore satisfy a further condition. They must demonstrate that the imperfect market outcome is inferior to a clearly specified (and fully costed) alternative state solution.[42]

Starting from a position of laissez-faire, the onus is on the proponents of state regulation to demonstrate the reasons why laissez faire should be abandoned. As Goodhart confesses, whilst he does not fully share the liberal denunciation of *all* regulation the,

> ...the prima facie case against [regulation] is strong enough to require the [regulatory] authorities to be required to justify the imposition of such regulations.[43]

The proponents of regulation must factor into their calculation the total costs of utilizing state power, including of course the costs of resource mis-allocation, tax collection costs, potential moral hazard costs and so forth.

The Public Choice theory of the State

Critics of the public interest theory, and especially of the economic 'market failure' variant of it, contest the way in which both the state and the motivations of individual

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[42] Many economists would argue further that markets can be efficient even though they may not meet the conditions of perfect competition. See B. Caplan, (1992) "The Efficiency of Free Competition", *http://www.gmu.edu/depa...economics/bcaplan/compet.*

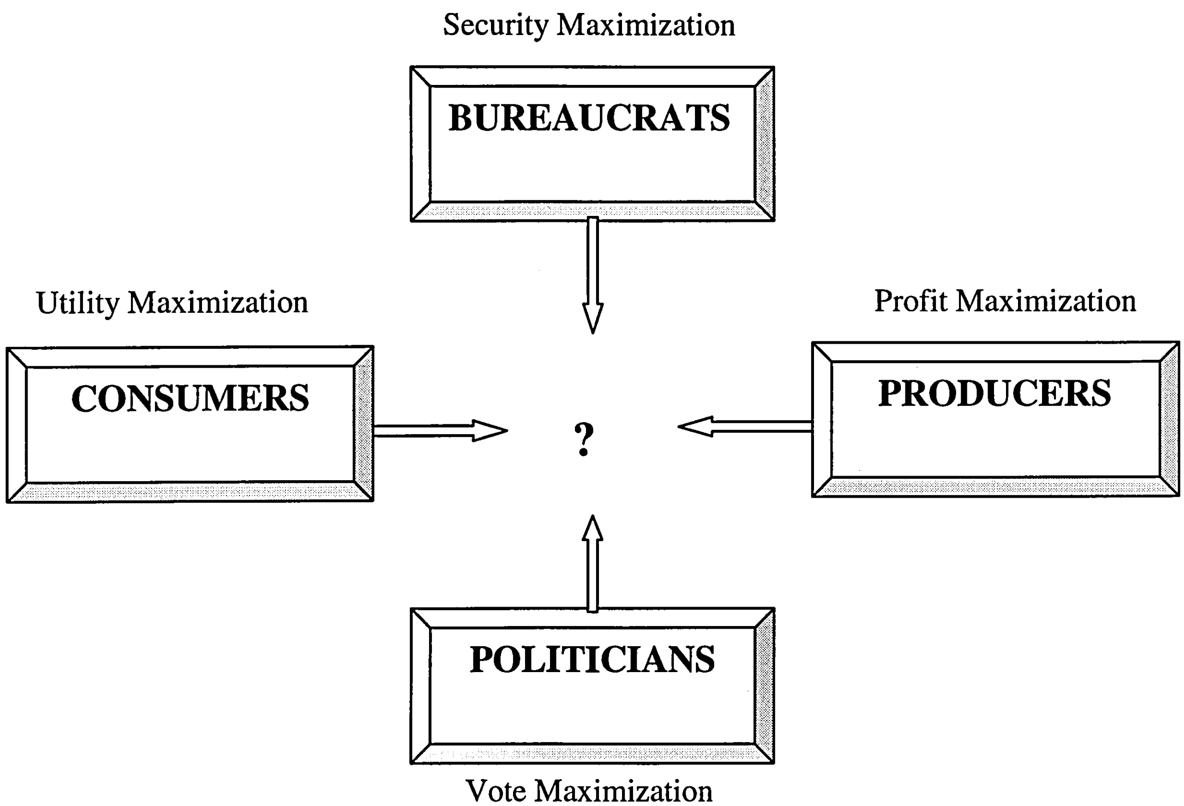
[43] Goodhart, C.A.E. (1987) "Investor Protection and Unprincipled Intervention?" February/ March, London IEA: *Economic Affairs*, p.8.

regulators are conceptualized. Implicit in the public interest theory is a conception of the state as being a perfect mechanism for the implementation of policies to secure the wider 'public interest'. Policy-makers and regulators are conceived to be neutral agents, able to unproblematically serve the public. This stands in stark contrast to their private market behaviour where they are assumed to behave in a way which maximizes their private self-interest.

However, public choice condemns the public interest theory as theoretically naïve, and also as being unsupported by the empirical evidence. Public choice theory maintains that politicians, bureaucrats and regulators will tend to follow their own interests, and do not promote the broader 'social interest' as such, despite their fiduciary obligations to do so. Public choice applies the paradigm of neo-classical economics (of rationality, self-interest and utility maximization) to the realm of politics. Individual actors, whether or not they are endowed with public office, act to maximize their private interests. Indeed, Mueller even defines public choice as being "...the application of economics to political science...The subject matter of public choice is the same as that of political science: the theory of the state, voting rules, voter behavior, party politics, the bureaucracy, and so on. The methodology of public choice is that of economics however. The basic behavioral postulate of public choice, as for economics, is that man is an egoistic, rational, utility maximizer."[44]

[44] Mueller, op. cit. p.1.

Figure 1. The Public Choice Model of Politics[45]



There is a wealth of evidence to support public choice theory, particularly from case studies of public policy in the United States.[46]

If the observations of public choice are taken seriously, it becomes difficult to sustain a credible argument for the use of self-interested actors to implement regulatory programmes. As Caplan (1993) states, "politicians and bureaucrats [and regulators] get positive incentives mainly from groups that have no interest in economic efficiency or any other....They get positive incentives from people who want government benefits, cost what it may to the general public. And most of the evidence is that politicians predictably heed these incentives." If policy makers, regulators and bureaucrats pursue their private interests then, even if a notion of the 'public interest' can be formulated, it is difficult to see how it could be effectively and consistently achieved.

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[45] The Political System, Mitchell, W.C. and Simmons, R.T., (1994) *Beyond Politics: Markets, Welfare, and the Function of Bureaucracy*, (USA: The Independent Institute).
[46] For example Buchanan *et alia* (1980), Mueller (1988), and Tollison (1989).

The Lighthouse in Economics: The Ingenuity of the Market

Arguments for government regulation based on the market failure rationale ignore the fact that markets have often overcome the seemingly insurmountable problems identified by welfare economics. As Dowd states "The provision of public goods was long regarded as a classic area where market failure justified government intervention. The argument was that the non-rivalrous nature of public good consumption and/ or the inability to exclude others from consuming public goods made it impossible for private producers to make sufficient return from producing these goods to induce those producers to provide such goods."[47] But, as Dowd continues "this argument overlooks the large number of ingenious ways in which the private sector is able to overcome these obstacles and provide public goods."[48]

The notion that the market would not produce public goods is also refuted by abundant empirical evidence that the private sector has provided them. A good example is the private provision of lighthouses in the UK before the mid-19th century. Coase exposed this example of a 'public good' being provided perfectly adequately by the market in his 1974 paper, "The Lighthouse in Economics"[49]. As Campbell recounts,

> When searching for an obvious example of a social good, a great many important textbooks, including Pigou's own have hit on lighthouse services as an example of a good which must be publicly provided because it is hard to create a private market in that good. In a truly brilliant way, Coase not only showed that the Pigovian argument is very woolly indeed but, and this is the Coase touch, that there was a perfectly thriving private market in British lighthouse services prior to 1842, which was ended only by the state buying the private lighthouses at enormous expense!

It is not only in the field of public goods that traditional market failure arguments have been attacked. In terms of arguments for regulation on the basis of imperfect competition, and especially the arguments based on abuses arising from monopoly power, critics have challenged the economic legitimacy of regulatory intervention.

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47 Dowd, K. (1999) "Participation in Civil Society," Pp. 31-43 in D. Campbell and N. D. Lewis (eds), *Promoting Participation: Law or Politics?* (London and Sydney: Cavendish Publishing Limited).
48 Ibid.
49 Coase, R.H. (1974) "The Lighthouse in Ecomonics", *The Journal of Law and Economics*, 17. No.2. 357-376.

In his Contestable Markets theory, Baumol[50] argued that it was the threat of entry and thus the absence of barriers to entry which determined the levels of competition within an industry. He argued, that so-called natural monopolies are very rare. He also argued that even where a natural monopoly exists, there will still be limits on its ability to raise prices. This is because if the natural monopolist raises prices enough, the other firms will enter the market and find that they can compete profitably at the higher price. The natural monopoly thus 'wins' in the sense of producing goods for less, thus being able to make a larger profit on each product sold. It can make money selling goods at a price at which other firms lose money and so retains control of the market. However, it retains the market only as long as its price stays low enough that other firms cannot make a profit. This is called potential competition - or the contestable markets theory.

The power of the natural monopoly is also limited by indirect competition. The price that the natural monopolist can charge is limited by the price and availability of substitutes. For example, if steel becomes very expensive due to monopoly production then people will switch to aluminum, wood or plastic. Similarly, if the cost of using the railways becomes prohibitive due to monopoly power then people will switch to alternatives such as cars, coaches or aeroplanes.

Market Failure or Paternalism?

The frequent failure of regulation to correct market failures has led many critics to argue that regulation is often ultimately founded on paternalism. As Caplan states, describing consumer protection regulation, "the real reasons for such regulations are paternalism (workers don't value safety enough, consumers aren't smart enough to avoid fraud, etc.)".[51] As Goodhart noted of the SIB's draft rules in 1987,

> The Board...appears to be embarked on a procedure of deciding what is current 'best practice', codifying it, and requiring everyone to ensure that they comply with that. This is 'nanny-state' intervention with a vengeance. Indeed, making everyone comply with 'best practice' is even more ambitious than the usual socialist demand that everyone must be, at least, 'average'...there are no economic arguments that I know to support the

[50] Baumol, W.J. (1952) *Welfare Economics and the Theory of the State.* (Cambridge: MA: Harvard University Press).
[51] Caplan (1993), *op cit.*

requirement that standards should be consistently applied at 'best- practice' quality...[this is] likely to inhibit competition and development; codification always does. [52]

On similar lines, Larry White identifies the market failure arguments used to argue for regulation and seeks to debunk them. He proffers three 'public interest' paradigms typically used to justify government economic regulation and presents a critique of each. The first paradigm that White presents is the *Fragile Markets* model. This is the traditional argument that if free competition is allowed to pertain, the large firms will drive out the small ones and then "pull up the gates" and prevent the entry of any new, small firms. The result will be a monopoly or oligopoly and a social welfare loss. From this line of reasoning, the argument follows that regulation is necessary.

He challenges this rationale for regulation on three fronts. He begins by contesting the notion that economies of scale and barriers to entry "are very serious in the industries for which the argument is made."[53] Moreover, he concludes that the absence of "substantial economies of scale or serious barriers to entry"[54] mean that this kind of market concentration is very unlikely to occur.

White then argues that even if substantial economies of scale were available in an industry, it would be folly to regulate with the objective of achieving an efficient market structure by artificially keeping a group of small, inefficient firms in existence. If economies of scale are such that an efficient market structure is characterised by a small number of large firms then surely it is this (i.e. a market structure made up of a small number of large firms) that should pertain - on economic welfare grounds.

Finally, White challenges the major premise of the argument, namely that it is typically large firms that "pull up the gates".[55] He argues convincingly that it is typically regulation that erects entry barriers and thus leads to greater market concentration. As examples, he cites CAB and British regulation of the airlines that prevented Freddie Laker from offering low-cost trans-Atlantic flights, and the Glass-Steagall Act that enforced an inefficient structure and low levels of competition in banking and securities.

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[52] Goodhart, C. (1987) *op. cit.*
[53] White, L. (1979) In *The Deregulation of the Banking and Securities Industries*, pp. 273-291. Edited by Goldberg, L.G and White, L.J. (Lexington, Mass. : Lexington Books), p.109.
[54] Ibid.

White's second paradigm is the *Widows-Orphans and Cheats-Charlatans* model. Proponents of regulation frequently argue that on the demand side of markets are widows and orphans, who don't act in their own interests, don't learn from mistakes, never acquire good advice, and have no friends to whom they can seek help. On the supply side are cheats and charlatans. These are "fly-by-night firms who do not expect to be in existence for the long run or, since the widows and orphans never learn, the sellers need not worry about reputations."[56] Whilst White accepts that there may well be a small minority of widows and orphans and cheats and charlatans in the markets, they are just that, tiny minorities; regulation *should not* be based on minority interests but on the basis of *costs and benefits*.

The final paradigm used to justify regulation is the *Investor Confidence* argument. This suggests that if a small number of investors are stung in a scandal the argument follows that they will withdraw from the market (keep their money under the bed), tell their friends, who will do the same, and the consequence will be severe damage to the size of the market. He mischievously comments that investors in this model are quite different to the widows and orphans in the previous model. In this model investors "do have memories, they do have friends, and they do give and receive advice."[57] He accepts, however that this does have a stronger basis in economics; it is an externality problem whereby the "dubious act of securities firm X affects firms Y and Z in an uncompensated non-market fashion."[58] However he concludes that the evidence indicates that this is a much less serious matter than is often argued.

The principal message of White's work is that the rationale for regulation, whilst frequently veiled in economic arguments, is more often grounded on nothing more than paternalism.

The Empirical Failure of the Public Interest Theory

In addition to the theoretical criticisms levied at the public interest theory, a further line of attack is based on empirical evidence on the failure of regulatory programmes

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[55] Ibid.
[56] *Ibid.* p.111.
[57] Ibid.
[58] Ibid.

to achieve their *supposed* public interest objectives. The public interest theory provides a basis for "establishing a regulatory system in the public interest".[59] It provides a benchmark of an 'ideal' market situation of fully competitive prices and output and it asserts that the public interest can be served by achieving these aims through regulation. If the aim of regulation is to create economic efficiency, then it is critical that there is a clear criterion against which to judge the effectiveness of the regulatory agency in this respect.

Before any regulatory programme is initiated, it should be clear that a number of questions have been asked:

- Does a market failure exist?

- Can a regulatory policy be designed and administered to correct the market failure?

- Would the benefits of the proposed regulatory programme outweigh the costs of carrying out the policy?

However, it is rare to observe these questions being asked, let alone being answered. It is therefore perhaps not surprising, given the disregard for the economics of regulation, that "Nearly all regulatory programs have fallen far short of dealing successfully with a real market failure in a cost effective manner".[60]

To begin with, critics of the public interest theory claim that cost benefit studies are seldom, if ever, conducted to determine the optimal level of regulation. Without such studies[61] the process of designing an optimal regulatory regime is impossible. Gower himself was dismissive of the need for a cost-benefit analysis when designing the FSA regulatory regime. Indeed, Gower actually boasts in his official review of investor protection that "In assessing the optimum degree of regulation I have not attempted any sort of cost-benefit analysis, partly because I am not competent to undertake it and partly because I am sceptical about its

[59] Philips, S. and Zecher, R. (1981) *The SEC and the Public Interest,* (Cambridge, Mass.: M.I.T. Press), p.19.
[60] Ibid.

practicability".[62] The absence of cost benefit studies, which are critical if the aim of regulation is to increase market efficiency, casts severe doubt on the public interest explanation for regulation. After all, how can anyone plausibly claim that the rationale for regulation was based on the correction of market failures in order to enhance market efficiency if the costs and benefits of regulation were not investigated?

Critics of the public interest theory have suggested that the effects of regulation are invariably perverse, as the internal dynamic at work within regulatory agencies encourages over-regulation (rules-escalation), anti-competitive regulation,[63] empire building, and incentives to serve the interests of the regulated (i.e. for the regulators to be captured). As Mitchell and Simmons state that

> Public choice scholars have shown that governments do not easily fix market failures; they usually make things worse. The fundamental reason is that the information and incentives that allow markets to co-ordinate human activities and wants are not available to government. Thus, voters, politicians, bureaucrats, and activists who believe themselves to be promoting the public interest are led by an invisible hand to promote other kinds of interests.[64]

Goodhart has argued that the real motive of the regulator is to minimise scandals during his term in office by imposing excessive controls. He argues that "there are patent pressures and incentives for excessive regulation",[65] as the regulators are generally personally blamed for any scandal and that the costs of regulation are generally spread out over the public.

The Modified Public Interest or 'Regulatory Failure' Theory

Recognition of these potential dangers or costs of regulation has spurned the regulatory failure model of regulation.[66] This approach has a large heritage, particularly among distinguished economists such as Charles Goodhart. The essence

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[61] Admittedly these are notoriously difficult to carry out, particularly with regard to creating a counter-factual against which the projected costs and benefits can be compared

[62] Gower, L.C.B (1985) Review of Investor Protection: Report: Part II, (London: HMSO), p.7.

[63] On similar lines, Alt and Chrystal argue that it has been the case that "...agencies initially set up to regulate monopoly come to be the principal obstacle to increased competition." (Alt and Chrystal, 1983, p.25).

[64] Mitchell, W. and Simmons, R., op. cit., p. 39.

[65] Goodhart, C.A.E. (1995) "Some Regulatory Concerns" LSE: *Financial Markets Group: Special Paper Series*, number 79. p.5.

[66] Philips and Zecher, *op. cit.*

of this argument is that structural, organisational and other defects and inefficiencies in the regulatory regime can lead to the failure of the regulator to achieve the supposed public interest objectives. As Posner says, the modified public interest argument states that, "Regulatory agencies are created for bono fide public purposes, but are then mis-managed, with the result that those purposes are not always achieved."[67]

Regulation involves various costs and perils:[68]

- The potential for regulatory capture.
- The danger that regulatory authorities may pursue their own agenda to promote their own welfare and objectives.
- Regulation may involve considerable direct and indirect costs.
- Regulation has the potential to significantly impair or distort competition.
- Risk averse regulators may create a bias towards excessive regulation.
- Regulation may have perverse effects - in what is described *as the problem of second best,* regulation which corrects one market failure may create or aggravate another one.
- Self-regulatory agencies may impose barriers to entry.
- A moral hazard may emerge whereby consumers perceive there to be an 'implicit contract' between themselves and the regulatory agencies. This may encourage investors to take excessive risks.

However, the regulatory failure model has been criticised. Posner attacks the modified version of the theory on three fronts: (i) that the modified theory ignores the fact that the socially undesirable results of regulation are frequently desired by groups influential in the enactment of the legislation; (ii) that there is little evidence to suggest that regulatory agencies are particularly prone to inefficiency; indeed the evidence suggests that agencies are highly efficient at attaining their real goals; and (iii) Posner argues that there is no theory as to why employees of regulatory agencies

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[67] Posner, R. (1974) *op. cit.*, p.337.
[68] Llewellyn, D.T. (1994) "Consumer Protection in Retail Investment Services: Protection Against What?" *Journal of Financial Regulation and Compliance*, Volume 3, Number 1. p. 44.

should be any less efficient, conscientious or hard working than any other organization. The incentives for self-betterment are present in regulatory agencies.

David Friedman is also critical of the regulatory failure theory. He argues that

> Many people, faced with the evidence on regulatory commissions and occupational licensing, argue that the solution is to 'make' them work in the public interest. This is tantamount to arguing that the consistent pattern of almost every regulatory agency and licensing body over the past century is merely accidental and could easily be altered. That is nonsense.

Friedman argues that, "Politics does not run on altruism or pious intentions, politics runs on power."[69] Arguing along similar lines, Stigler argues that putting aside the lack of any explanation of why a regulator should be any less efficient at his task than any other enterprise (Stigler 1971), the widespread observance of regulatory failure leads to the suspicion that something more fundamental than incompetence or inefficiency is at work. As Philips and Zecher point out:

> While it is possible to conceive of better regulatory laws and better administration of regulatory programs that deal with real market failures in a cost effective manner, the widespread absence of such laws and programs leaves a nagging suspicion that something more fundamental is amiss. It is this observation that is mainly responsible for some revisions to the economic theory of regulation that have placed more emphasis on the effect that regulation has on resource allocations and the process by which the public chooses which regulatory program it wants.[70]

The modified form of the public interest theory advocated by the likes of Llewellyn, has been subjected to considerable criticism. The source of much of this criticism has come from public choice scholars. However, public choice has not only advanced a critique of the public interest theory, it has also developed an alternative theory of regulation. The public choice theory of regulation is now considered.

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[69] Friedman, D. (1995) *The Machinery of Freedom*, (Open Court Publishing; La Salle, Illinois), p.44.
[70] Philips and Zecher, *op. cit.*, p.21.

4. The Public Choice Theory of Regulation

The public interest theory of regulation purports to provide an explanation for why government regulation *should* serve the public interest based on the implementation of regulatory programmes designed and implemented by altruistic public servants to correct market failures. In contrast to the teleological public interest theory, the public choice theory offers an alternative instrumental explanation for the interests served by government regulation. As Meier states the "prior theories of regulation by economists...were normative, stressing what the purpose of regulation *should* be rather than explaining why regulation produced the policies that it did."[71] Stigler, in his seminal article in 1971 advanced a radically different perspective on the regulatory role of the state.

George J. Stigler: The Theory of Economic Regulation

Writing in the Bell Journal of Economics and Management Science, and building on earlier work by Olson (1971), Downs (1957), public choice scholars such as Buchanan et al (1962), Niskanen (1971), and political scientists such as Truman (1951), Herring (1936), Bernstein (1955) and Edelman (1964), Stigler (1971) contended that the market failure theory of regulation fails to capture the way in which regulation actually works in the real world. Stigler sought to replace the normative public interest theory, which dominated discourse on regulation in economics, with a positive, testable theory based on economic reasoning and grounded in empirical evidence. In Stigler's own words,

> A central thesis of this paper is that, as a rule, regulation is acquired by an industry and is designed and operated primarily for its benefit.[72]

The Stiglerian model characterizes regulation as the product of a market-like process of exchange whereby regulators and policy makers provide beneficial regulations to private interest groups in return for political support. Both private interest groups and policy-makers act to satisfy their individual self-interest; policy makers need political

[71] Meirer, Kenneth, J. (1988) *The Political Economy of Regulation: The Case of Insurance*, (USA: University of New York Press).
[72] Stigler, G. (1971) "The Theory of Economic Regulation", *Bell Journal of Economics and Management Science*, 2,1, Spring, p.3.

support in order to stay in office and industry interests want beneficial regulations in order to boost profitability. The result of this exchange is a situation similar to a market whereby industry has a demand for regulation and regulatory officials supply it. McCormick suggests that the potential size of the market for beneficial regulation is very considerable:

> [T]he strategic use of regulation is pervasive. There is a lot of wealth at stake there, and management would be remiss in their fiduciary responsibilities if they ignored profits available through (legal) manipulation of governmental processes. The decision to invest resources lobbying to prevent the entry of rivals, to form a regulatory cartel, or to impose costs on existing rivals does not differ materially from all the other decisions that managers make on a daily basis." [73]

Stigler goes on to advance a series of characteristics for industry groups that would be likely to demand (or be successful) in demanding beneficial regulation. He considers the issue of state occupational regulation and cites four variables that he considers would make state regulation more likely: (i) a large number of practitioners; (ii) high practitioner per capital income; (iii) practitioners should be concentrated in urban areas; and finally (iv) no cohesive opposition to licensing should be found. However, the empirical results presented by Stigler are unpersuasive. Meier states that his "results must be characterised as disappointing…The results, 14% of the variation explained, would be considered so trivial by political scientists…that they might even not report them."[74]

Despite the failure of Stigler to present persuasive empirical evidence his initial (1971) paper, his ideas encouraged other economists to pursue the problem further. The next economist to do so was Richard Posner.

<u>Richard Posner: Regulation as a Mechanism for Wealth Transfers</u>

Posner, sought to tidy up and formalize some of the claims left implicit by Stigler. However, he began with a critique of the public interest notion that "regulation is supplied in response to the demand by the public for the correction of inefficient or

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[73] McCormick, R.E. (1984) "The Strategic Use of Regulation: A Review of the Literature," in Rogowsky, R.A, Yandle, B. (eds) The Political Economy of Regulation: Private Interests in the Regulatory Process. (Federal Trade Commission: Law and Economics Conference), pp. 26 – 27.
[74] Meirer, *op. cit.* p.20.

inequitable market practices."[75] He identifies two assumptions that he considers underlay economic policy (in the US) between 1887 when the first Interstate Commerce Act was passed and 1958 when the Journal of Law and Economics was founded. These are, that economic markets are extremely fragile and apt to operate very inefficiently (or inequitably) if left alone, and that government regulation is virtually costless. On the basis of these assumptions, he argues, government regulation of the economy was simply a response to public demands for the "rectification of palpable and remediable inefficiencies and inequities in the operation of the free market."[76] Behind each of the regulatory initiatives of the state were market imperfections which justified government regulation that was assumed to operated effectively and without cost.

Were the public interest theory an adequate explanation for the use and interests served by government regulation, it would be expected, so Posner argues, that regulation would mainly be imposed on highly concentrated industries (where the danger of monopoly is greatest) and in industries that generate substantial external costs and benefits. However, according to Posner, fifteen years of research show that "regulation is not positively correlated with the presence of external economies or diseconomies or with monopolistic market structure."[77] He cites trucking, the airlines and stock brokerage as examples. He also argues that "The conception of government as a costless and dependably effective instrument for altering market behaviour has also gone by the boards."[78]

In contrast to the idealism of the public interest theory, Posner asserts that the outcomes of regulation are in fact policy outputs demanded by private interests. Regulation acts to serve "the private interests of politically effective groups,"[79] and to produce transfers of wealth to them. He also accepts that much regulation may be the result of coalitions between industry and consumer groups, with, as Horowitz explains "the former obtaining some monopoly profits as the latter obtains better service or lower prices than either would in an unregulated market."[80] As such Posner[81] is able

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[75] Posner, R, (1974) *op. cit.*
[76] Ibid.
[77] Ibid.
[78] *Ibid.* p.337.
[79] *Ibid*, p.335.
[80] Horowitz, R.B. (1989) *The Irony of Regulatory Reform*, (New York: Oxford University Press), p.37.

to characterize regulation as being a kind of "state-sanctioned redistributive politics"[82] Hence the metaphor of regulation as a form of taxation; but taxation which redistributes wealth from the organized to the disorganized.

He identifies three schools of thought in the private interest capture theory. The first is, what he rather pejoratively terms the Marxists and Muckrakers approach. This he equates with the notion that government regulation is part of the machinery of bourgoise capitalist exploitation.[83] Regulation is thus considered a necessary means of tempering the worst excesses of capitalist 'exploitation." As Douglas exclaims, 'They [regulatory commissions] have become more and more the outposts of capitalism; they have been given increasingly larger patrol duties, lest capitalism by its own greed, avarice, or myopia destroy itself.'[84]

The second is the political scientists' version. Posner cites Truman and Bentley as prime exponents, but perhaps the best examples are those of Bernstein (1955) and Kolko (1963). Although Posner concedes that political science has contributed *some evidence* on the importance of interest groups on legislative and administrative processes, he claims the approach of political science to be "almost totally devoid of theory."[85] The theory there is, states merely that over time, regulatory agencies come to be dominated by the industries they are supposed to regulate. This, according to Posner is more a lose hypothesis than a real theory of regulation.[86]

Finally, is the economic theory of regulation. Although derived from the theory of political science, it departs radically from it, discarding the assumption of *pristine legislative purpose*, conceding the possibility of capture by interest groups other than the regulated firms, and finally replacing the 'capture' metaphor with the

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[81] Posner, R. (1971) "Taxation by Regulation", *Bell journal of Economics and Management Science*, 2/1, Spring, 22-50.
[82] Horwitz, op. cit.
[83] In fact, Moran does identify a stream of thought from Marxist structuralism which conceives of regulation as being a "functional response to the imperatives of capitalist development." (Moran, 1986, *op. cit.* p. 188).
[84] Douglas, 1940, p. 244.
[85] Posner, 1974, *op. cit.*, p.341.
[86] In fact, contemporary political scientists such as Meier (1988) condemn the Stiglerian-Posnerian approach as one which "presents a simplistic view of pluralism less advanced than the work of Truman and others that was written 20 years earlier." (Meier, 1988, p.22). The more recent developments to the Stigler-Posner-Peltzman theory have incorporated some of the contributions of political science.

economics notions of supply and demand. The economic approach also adopts the neo-classical paradigm of rationality, self-interest, utility maximization, and so on.

The economic theory of regulation, according to Posner is properly founded on the notion that economic regulation (which is the expression of the government's monopoly on the legitimate use of coercive force) can be viewed as a product whose allocation is governed by the laws of supply and demand. By focusing on supply and demand, Posner draws attention to the value of regulation to interest groups and individuals. As with any other product, Posner argues that more of the product will be supplied to those who value it the most.

Posner, then rightly states that the effects of regulation are frequently similar to those a cartelization; regulation invariably erects barriers to entry, exemptions from competition law, and price controls. He argues that it will be those industries that are unable to maintain cartels themselves who will demand government support, through regulation, to obtain and maintain them. It will be those industries which are diverse, have many suppliers and which lack other favourable characteristics necessary for successful cartel management who will obtain (or seek to obtain) favourable regulation.

The theory of groups (Olson, 1971; Downs 1957) suggests that it will be small, well organised groups with large per capita stakes in the policy that will dominate over the more diffused interests of larger less concentrated groups; such as ordinary members of the public. An individual voter faces *costs* of informing himself about an issue and its implications for his wealth. In addition, the individual faces the costs of finding out how to lobby for any particular cause. Moreover, since any individuals' gain from a change in regulatory policy is likely to be *negligible,* it is therefore unlikely that on a cost - benefit basis the rational individual will decide to lobby. If this is combined with the costs of organisation, it becomes clear that the large, diffuse group is unlikely to oppose a policy even if it is patently opposed to its own best collective interest.[87] Olson states that "The multitude of worker, consumers, farmers and so on are organised only in special circumstances, but business interests

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[87] David Friedman (1995) argues further that, "A politician who can regulate an industry gets much more by helping the industry, whose members know and care about the effects of the regulation, than by helping the mass of consumers who do not know they are being hurt and who would not know if they were being protected. An astute politician can ... both help the industry and get credit for protecting the consumers. The consumers, whose relationship to the industry is a very small part of

are organised as a general rule."[88] The better-organised business interests will seek regulation. In essence a political auction occurs where the highest bidders receive the right to tax the wealth of everyone else - regulation in this sense is a means of wealth redistribution, not in the form of notes and coins but in the form of a regulated price or an entry control to stabilise a cartel (Posner 1974).

McChesney[89] identifies further the characteristics of an industry that would be likely to demand and regulation:

- The industry should employ many people - this increases political power.
- The industry should be heavily unionised, this allows the free-rider problems of lobbying to be overcome and greatly increases political effectiveness.
- The industry either should be highly concentrated or should have a well-organised trade association to overcome free-rider problems.
- The industry should be economically important.
- The industry should be concentrated in politically important locations.
- The natural opponents to the regulation (either their competitors, who stand to lose producer surplus, or consumers who stand to lose consumer surplus) should be weak.
- The regulation-seeking industry should have a good public image i.e. not having had obscene profits.
- The industry's objectives should be compatible with the 'public interest' goals of an influential political ideology or interest group.
- The industry should be shocked by some "exogenous factor which.... raises the potential reward of anti-competitive regulation, upsets existing political equilibrium, and gives policy-makers reason to pay attention to and invest their time and political capital in the issue of concern to the favour-seeking industry."[90]

Consumers and producers supply campaign contributions and votes, and politicians supply regulation. The outcome of this political-regulatory market is determined by

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their lives, will never know what prices they would have been paying if there were no regulation" (Friedman, 1995, p.44).

[88] Olson, M. (1971), *The Logic of Collective Action* (Harvard University Press), p.143.

[89] In Rogowsky et al, *op. cit.*

[90] McChesney in Rogowsky, *op. cit.*, pp.160-161.

three factors: (i) the relative organizational costs of different groups; (ii) the political system; and (iii) competition in the political market.

Sam Peltman: Formalizing the Theory of Economic Regulation

The next major contribution to the economic theory of regulation came in 1976 when Sam Peltzman wrote *Toward a More General Theory of Regulation.*[91] In this paper, Peltzman declared that,

> A common, though not universal, conclusion has become that, as between the two main contending interests in regulatory processes, the producer interest tends to prevail over the consumer interest.[92]

As with Posner before him, Peltzman's work sought to add a greater degree of economic rigour to the private interest theory of Stigler. As he states,

> What Stigler accomplished in his Theory of Economic Regulation was to crystallize a revisionism in the economic analysis of regulation...The revisionism had its genesis in a growing disenchantment with the usefulness of the traditional role of regulation in economic analysis as a deux ex machina which eliminated one or another unfortunate allocative consequence of market failure. The creeping recognition that regulation seemed seldom to actually work this way, and that it may have engendered more resource misallocations than it cured, forced attention to the influence which the regulatory powers of the state could have on the distribution of wealth as well as on allocative efficiency...The focus on regulation as a powerful engine for redistribution shows clearly in such works as Jordan's Producer Protection and Posner's Taxation by Regulation. The common role of regulation in this literature is as a fulcrum upon which contending interests seek to exercise leverage in their pursuit of wealth. A common...conclusion has been that, as between the two main contending interests in regulatory processes, the producer interest tends to prevail over the consumer interest.[93]

He accomplishes this by conceptualizing regulation as being about wealth transfers as Posner did. He locates the wealth transferring activity of government in a theory of political coalitions. Indeed, he redefines the Stigler work in this vein, stating that it

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[91] Peltzman, S. (1976) "Toward a More General Theory of Regulation", *Journal of Law and Economics*, 19, August, 211-240.
[92] Peltzman, *op. cit.* p.212.
[93] *Ibid.* p.212-213.

[Stigler's work] is "ultimately a theory of the optimum size of effective political coalitions set within the framework of a general model of the political process."[94] The effects of regulation is to produce a political auction, wherein the highest bidder receives the right to tax the wealth of everyone else, and Peltzman's theory seeks to discover why the successful bidder is a numerically compact group. The answer to this quandary lies in the relationship between group size and the costs of using the political process.

There are two pivotal issues here. The first is that the size of the dominant group is limited by the absence of something like an ordinary market for regulation. Voting, even in western democracies is infrequent and is concerned with a whole raft of issues. In order for an individual to play an active role in opposing an undesirable policy, he must spend resources in order to inform himself about its implications for his wealth and also find out which politicians are likely to support him. This information cost has to off-set any prospective gains in order for it to be beneficial to the voter to act. If the voter faces a small per capita gain, he will rationally chose not to incur it. Therefore, as public choice predicts, the numerically large, diffuse groups (such as consumer groups) are unlikely to launch effective opposition to policies, even though they may be inimical to their collective interest.

The second pivotal issue for Peltzman is the cost of organization. It is not sufficient for the group to recognize its interests, it must also organize in order to translate that interest into support for a politician who will in turn support them. The group may have to fund the political party that is likely to offer it support, lobby policy-makers, finance campaigns, bribe those in office. However, the costs of organization, and specifically of overcoming free-rider problems (which increase as group size increases) will act as another constraint on the size of groups that will ultimately dominate the political process.

Pelzman draws a number of empirical conclusions from his analysis. One interesting corollary of his analysis being that,

> Regulation will tend to be more heavily weighted toward 'producer protection' in depressions and toward 'consumer protection' in expansions.[95]

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[94] *Ibid.* p.212.

This is capable of empirical testing and as Goodhart points out, seems to fit with much of the financial regulation in the 1980s in the UK.[96]

The Implications of the Stigler-Posner-Peltzman Theory

(i) The Private Interest Theory

In the extreme, the public choice theory suggests that private interests that are unable to impose a self-regulatory cartel, will, in certain circumstances, 'buy' regulation from politicians. They will then use regulation, "to restrict entry of rivals, to prevent non-price competition, to differentially impose costs on members of an industry, or to restrict the production of substitute goods and services."[97] Friedman comments on the pervasiveness of this phenomenon:

> In the United States in this century the predominant form of monopoly has not been natural monopoly, artificial monopoly, or direct state monopoly, but state monopoly in private hands. Private firms, unable to establish monopolies or cartels because they had no way of keeping out competitors, turned to the government. This is the origin of the regulation of transportation - the Interstate Commerce Commission (ICC) and the Civil Aeronautics Board (CAB). A similar process is responsible for occupational licensing, which gives monopoly power to many craft unions, among them the most powerful and probably the most pernicious craft union of all, the American Medical Association.[98]

This element of the theory, (i.e. where powerful interest groups are able to buy regulatory privileges from government) is tailored very much to the US political system where two key characteristics of the system make the 'buying' of regulation a very real possibility.

First, the US political system is one where individual politicians are more autonomous and independent of political party than in the UK system. Party discipline in the US is very weak compared to the UK, and the support given to candidates by party in being elected to Congress tends to be less than the support given to Parliamentary candidates in the UK. A consequence of this lack of financial support from Party is that individual candidates, if they are to be successful, must raise significant funds in the form of campaign contributions from their supporters. The

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[95] *Ibid.* p.227.
[96] Goodhart, C. *op. cit.*
[97] McCormick in Rogowsky *op. cit.*, p.14.

second major difference between the US and UK systems, is that the rules on receiving such contributions are very much less restrictive than in the UK[99]. The combination of candidates' desperate needs for campaign contributions and low party discipline means that politicians can pursue their own crusades and agenda regardless of party. This means that private interest groups seeking regulation (and with the funds to buy it), will find a fertile supply of regulation within the US political system (Stigler 1974).

(ii) The Regulatory Tri-Partite Model

A less extreme version of the private interest theory is the regulatory tri-partite model (McCormick, 1984) otherwise known as the 'Bootleggers and Baptists' theory of regulation (Yandle, 1983). This version of the theory suggests that private interests, on their own would be unable to generate sufficient influence over enough politicians to obtain the regulation they want. The theory suggests that the success of private interests in achieving regulation will thus be determined by their ability to form a coalition with 'public interest' groups that can be crucial in obtaining political support. Calomiris and White (1984) suggest that public opinion on widespread bank failures was critical in arousing the political will to originate federal deposit insurance programmes. However, once this decision was taken, the debate moved into the *smoked filled offices of Congress* where private interests were then able to take over. The regulatory tri-partite model is undoubtedly widespread:

> The ICC illustrates what might be called the natural history of government intervention. A real or fancied evil leads to demands to do something about it. A political coalition forms consisting of sincere, high-minded reformers and equally sincere interested parties. The incompatible objectives of the members of the coalition (eg., low prices to consumers and high prices to producers) are glossed over by the fine rhetoric about the 'public interest,' and 'fair competition,' and the like. The coalition succeeds in getting Congress (or a state legislature) to pass a law. The preamble to the law pays lip service to the rhetoric and the body of the law grants power to governments to 'do something.' The high-minded reformers experience a glow of triumph and turn their attention to new causes. The interested parties go to work to make sure that the power is used for their benefit. They generally succeed. Success breeds its problems, which are met by broadening the scope of intervention. Bureaucracy takes its toll so

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98 Friedman, D. *op. cit.*, p.39.

99 Although, of course this is not to say that there are not controls on fund-raising in America.

> that even the initial special interests no longer benefit. In the end the effects are precisely the opposite of the objectives of the reformers and generally do not even achieve the objectives of the special interests. Yet the activity is so firmly established and so many vested interests are connected with it that repeal of the existing legislation is nearly inconceivable. Instead new government legislation is called for to cope with the problems produced by the earlier legislation and a new cycle begins.[100]

As Yandle notes, "The most successful ventures of this sort occur where there is an overarching public concern to be addressed (like the problem of alcohol abuse) whose 'solution' allows resources to be distributed from the public purse to particular groups or from one group to another (as from bartenders to bootleggers)."[101]

(iii) The Capture Theory

The capture theory concedes that regulation may be initiated for any number of reasons, ranging from paternalism, political expediency, through political response to scandal or even, possibly, out of genuine concern for the public interest. Indeed there is considerable evidence that, particularly in the UK, it is response to scandal which is a major source of regulation; ranging from the Banking Acts of 1979 and 1987, responses to the fringe banking crisis and Johnson Matthey, respectively and the Dangerous Dogs Act, regulations on seat-belts in school mini-buses and hand gun regulation. Booker (1994) argues that regulation in Britain over the last decade has often been based on 'Five Shibboleths' all charged with a high moral tone:

- Hygiene;
- Safety;
- Protection of the environment;
- Protection of the consumer;
- Promotion of caring, especially for the old and young.

He argues that a consistent pattern of regulation has emerged. "First, generated by some real or imagined problem, there is a rising tide of public concern, whipped up by the media and by pressure groups. This produced a clamour for something to be done,

[100] M. Friedman, 1983, *Free to Choose*, pp.240-241.

to which the government responded with legislation or regulation."[102] Goodhart argues along similar lines, "the regulatory process in the UK,...more often represents a reaction, sometimes an over-hasty reaction, to some scandal which public opinion has put on the political agenda."[103] A typical scenario is that a well-publicized scandal occurs which arouses indignation in the media and amongst vocal public interest pressure groups. A report is commissioned to investigate the 'scandal' which then leads to a government White Paper and then to a Bill. Numerous influences are exerted on the content of the Bill in parliament as individual politicians are influenced by private interests, public interest groups and personal interests. A regulatory agency is then established to enforce the 'public interest' regulation.[104]

This theory then predicts that the regulatory agency set up to administer the regulation will become the captive of private interest groups (the same types of groups that were buying regulation under the other model) and that the group achieving the capture will impose regulations to serve their own interests and pervert the stated objectives of the regulation. As Goodhart states,

> At the outset, therefore, regulation in the UK *does* have some considerable public service characteristics, though generated perhaps rather as a defensive response to a perceived public outcry than as a planned form of social engineering. The problem is that public, and political attention soon moves on elsewhere, and the regulators and regulated are left to live in close embrace with each other for better or for worse. Under these conditions, there must be an inevitable tendency for the regulators to seek an easy cohabitation with the regulated. The regulated will 'capture' the regulators. Although the importance of the supposed distinction between self-regulation and statutory, external regulation was, I believe, absurdly exaggerated, the use of practitioners to form the main body of regulators hardly diminishes the likelihood of 'capture'."[105]

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[101] Yandle, B. (1983) "Bootleggers and Baptists – The Education of a Regulatory Economist", *AEI Journal on Government and Society*, May/ June, pp.13-14.
[102] Booker, C. (1994) *The Mad Officials,* (London: Constable), pp.20-21.
[103] Goodhart, C. (1987) "Investor Protection and Unprincipled Intervention?" February/ March, London IEA: *Economic Affairs*, p.23.
[104] Booker comments on the trend towards establishing private bodies with "quasi-religious" public interest casues. The high moral tone of the task of the bodies renders them beyond reproach.
[105] Ibid.

Blundell develops this further, arguing that "Industry can, however, be very quick to exploit government regulation to its own benefit even when it has not lobbied for the relevant legislation."[106]

Public Choice Investigations of the Interests Served by Regulation

Since Stigler's seminal paper in 1971 a number of economists have attempted to investigate the interests served by regulation. Areas as diverse as mattress flammability standards (Linneman 1980), the Food and Drug Administration (Peltzman 1974; Termin 1979), The Factory Act of 1833 (Marvel 1977), the regulation of the underground coal industry (Kalt 1984), jitney regulations (Eckert and and Hilton 1972) and cable-television (Marvel and Ray 1983) have been subjected to investigations. The studies have sought to elucidate the origins of regulation and to examine the impact of regulation, specifically investigating whether industry interests have benefited from regulation. For the purpose of my study of the interests served by the FSA, I shall now review those studies related specifically to financial services. The studies reviewed are those of Glass-Steagall, of the SEC and of Federal Deposit Insurance.

Studies of Glass-Steagall

The Glass-Steagall Act enforced the separation of commercial and investment banking in the US. Shughart (1988) found that Glass-Steagall represented a, "government sponsored market-sharing agreement for the financial services industry."[107] Shugart argues that the Glass-Steagall Act had the effect of creating barriers that prevented any direct competition between commercial and investment banking. He contends that the effects of Glass-Steagall were analogous to those of collusive cartels where they divide the market in order to maximize joint profits. He argues that the Act, whilst imposing costs, generated no apparent benefits for depositors. Finally, he argues that the Act, by restricting the freedom of the commercial banks to purchase equities, could actually have made them more risky

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[106] Blundell, J. (1994) "Government Regulation: The Way forward" *London*: *Economic Affairs*, June. p.13

[107] Shughart II, W.F. (1988) "A Public Choice Perspective of the Banking Act of 1933", In The Financial Services Revolution: Policy Directions for the Future. Edited by C.England and T.F. Huertas. (The Cato Institute), p.101.

and increased the probability of bank failure. This, he suggests is because it prevents them from holding an efficient asset portfolio

In another study on the Glass-Steagall Act, Macey (1984) casts doubt on the White interpretation of the interests served and examines how producers have benefited at the expense of other producers. He proposes two alternative explanations for Glass-Steagall. It was either a Congressional mistake (made from the best intentions), or it was a response to private interests. He rejects the first as implausible as such an extreme measure as prohibition of securities activities would not occur by mere folly. He therefore concludes that Glass-Steagall was a means by which the investment bankers succeeded in eliminating the competition of commercial banks who had increasingly made inroads into the investment sector. They were able to argue for Glass-Steagall by exploiting the situation with a stroke of political opportunism of the highest order. Macey highlights the fact that Congress blamed the commercial banks squarely for The Depression which placed them in a very weak position. The investment bankers took advantage of this change in the balance of power and lobbied for legislation to exclude competition for their business.

Studies of SEC Regulations

An area which has attracted a great deal of attention from public choice scholars is the SEC and its regulation of securities exchanges. Philips and Zecher (1982) argue that if the market failure/ public interest theory of regulation were a true description of the origins of the SEC, then the SEC would only have been established and run for over fifty years if three conditions had been met: (i) if there had been convincing evidence that fraud, deceit and price manipulation were widespread; (ii) only if regulatory programs could be designed that would actually reduce these undesirable things; and (iii) only if the cost of regulatory programs was less than the benefit to society of reducing fraud, deceit and so forth. However, according to Philips and Zecher, "no documentation by the SEC is available that shows that their regulatory programs have reduced the amount of share manipulation fraud and deceit"[108]

Moreover, Philips and Zecher (1982) and Benston (1977), considered the SEC disclosure requirements and identified a number of private interest groups that clearly

[108] Philips and Zecher, *op. cit.*, p.19.

benefited from the SEC's existence at the expense of the institutions listed on the exchange:

- Securities lawyers.
- Financial accountants.
- Financial analysts.
- Portfolio managers.
- Securities market professionals.
- The army of well paid staff at the SEC.

They also applied the Stiglerian theory of regulation to the case of the deregulation of NYSE fixed commissions. They argue that although there were significant and powerful private interest groups whose interest was served by fixed commissions, changes in the power and importance of institutional investors were conclusive in their demise. By October 1966 institutional investors represented 42.9% of NYSE total share volume, compared to 25.4% in 1956.[109] These powerful institutions increasingly pressed for competitively determined commissions and increasingly sought to circumvent them - by various non-price means.

The catalyst for the deregulation came when the Justice Department challenged the NYSE commission fixing in 1968. The SEC resisted the change and submitted, "A study listing eighteen major problems caused by the foreseen *destructive competition* that would result in the absence of fixed commissions."[110] The main objections were based on the effects of competition on increasing market concentration by destroying the smaller firms and also its effect on investor confidence. They alleged that price competition would lead to *chaos in the financial markets*.

A long running case ensued in which those with an interest in maintaining fixed commissions - the exchange itself, securities firms and the OTC market - argued vociferously against the change. The opposition to fixed commissions was growing however and was enshrined in the Securities Investor Protection Act of 1970 which found that, "Fixed commissions were a hindrance to competition and should be

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[109] *Ibid.* p.55.
[110] *Ibid.* p.57.

removed." The writers conclude that the regulatory tax imposed by fixed commissions, especially on the larger investor, was so great by the period 1960 - 1974 that the power of the private interests in support was undermined. This loss of power was combined with the growth in the power of another private interest group - the institutional investors - who were able to succeed in lobbying for competitively determined commissions.

Noll and Owen (1983) also considered the SEC sanctioned self-regulation of the NYSE (Exchange) before 1975. They concluded that the fixing of commissions resulted in the preventing of price competition and set an artificially high price for stock brokerage services. They argue that it was the large institutional traders, whose business was especially profitable to brokers at fixed prices, who made up a special interest group which had a clear incentive initially to oppose regulation and to advocate deregulation. However, another group, the stockbrokers, initially supported regulation and opposed deregulation. This was for the reason that existing regulation made the stockbrokers better off because it enabled them to operate as a cartel to enrich themselves at the expense of volume purchasers such as the large mutual funds. They argue that regulation, by keeping prices above the competitive level, had the effect of making some of the brokerage firms highly profitable but also had the effect of allowing some inefficient and badly managed firms to succeed. But, as they conclude "...regulation created such an interest, one that subsequently fought hard against deregulation."[111]

In another example, Stigler (1964) in his seminal study of the SEC disclosure requirements, examined the values of the new issues for five years before and after the SEC rules compared to the market average. He finds no evidence that the SEC requirements increased the quality of new issues sold to the public (in terms of the variability of values) and thus concludes that there are grave doubts that SEC accounting disclosure requirements "saved the purchasers of new issues one dollar."[112] Furthermore he argues that SEC regulations, which required onerous standards of reporting and record keeping by listed firms, acted as a barrier to entry, preventing new issues being made on the exchange.

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[111] Noll, R. and Owen, B. (1983) *The Political Economy of Deregulation* (Washington: American Enterprise Institute), p.35.

Studies of Federal Deposit Insurance

Calomiris and Flood (1994) examined the interests served by federal deposit insurance. In the northern states where branching laws forced unit banking, deposit insurance was in great demand and had been tried, unsuccessfully before. To qualify the link between unit banking states and support for deposit insurance White and Calomiris (1994) looked at the correlation between support for deposit insurance and whether the supporters were representatives of unit banking states. They found that of the thirteen states strongly in favour of deposit insurance, five of these were among the eight states that introduced state level deposit insurance. They also found that these thirteen states had more fragile banking systems than other states, measured by bank and business failure rates, median bank size, branching ratios and average bank assets. The destabilising effects of unit banking and the clear record of widespread failures (especially connected with agricultural slumps) provide a clear rationale for the demands of the unit bankers for federal deposit insurance. They conclude that federal deposit insurance was won by unit bankers who could not survive against the competition of the bigger national banks without it. Not only did deposit insurance introduce serious moral hazard but it also allowed a deeply inefficient banking structure to perpetuate to the expense of the more efficient national banks and to the public.

The empirical literature surveyed above presents a very bleak picture of the interests served by government regulation. In every case regulation has either served producers, or served a sub-set of a producer group at the expense of both other producers and the public. The apparent success of the public choice theory as an explanation for the interests served by regulation is not to suggest that the public choice explanation is uncontested. In fact, public choice theory has been criticized. These criticisms are now considered.

[112] Stigler, G. (1964) "Public Regulation of the Securities Market" April, *Journal Of Business,* University of Chicago, 37, Number 2. Reprinted in Stigler, G. (1975) *The Citizen and the State:*

5. A Critique of the Public Choice Theory

Despite its apparent success, the public choice approach (and more specifically, the public choice theory of regulation) has undergone sustained attack, especially from critics in economics and political science. Many critics have focused on the adoption by the public choice theory of the paradigm of neo-classical economics. First, the assumption of rational choice has been the subject of much debate, even within the field of economics. As Eggertson notes, "Critics have argued that individuals tend to have unstable preferences, that they do not observe the principle of transivity in their choices, and that people are not calculators who work at lightening speed through their complete set of data relevant to their decisions."[113] Simon famously advanced the notion that man's rationality was bounded and that, rather than being an 'optimizer', man is a 'satisficing' animal who seeks to obtain a level of aspiration. However, it should be remembered that these assumptions are just that, assumptions. Theories and models are abstractions from reality, they make simplifying assumptions in order to make *a priori* predictions about the real world. In addition, and more importantly, attacking the basic, simplifying assumptions of a theory need not detract from the theory's utility as an explanatory tool. The mere fact that individuals do not act as *homo economicus* all of the time does not invalidate the public choice theory of regulation – especially given the strong empirical evidence which supports it.

Critics have also attacked the conception of public choice government as a 'black box' where individual policy-makers are given no scope other than to pursue narrowly defined self-interested behaviour. Thus, for example Forrence and Levin (1990), Kalt and Zupan (1984; 1990) and Weingast (1981) have all re-asserted the scope for policy-makers to engage in on-the-job ideological consumption. The concept of regulatory slack[114] (Levine and Forrence 1990) and analysis of agency behaviour (Niskanen 1971; Buchanan et al 1962; Bernstein 1966) has also provided an insight into regulatory behaviour which does not appear to be explained by the Stigler-Posner-Peltzman theory.

Finally, economists such as Goodhart and Llewellyn have suggested that whilst the public choice approach *may* be a valid explanatory framework for

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Essays on Regulation (University of Chicago Press. pp. 78-100),p. 87.

[113] Eggertson, T. *op. cit.*, p. 8.

[114] Regulatory slack refers to the freedom that regulators may enjoy - and utilise to pursue personal agendas - when mechanisms for controlling them are imperfect.

examining the interests served by regulation in some political arenas – such as America and the European Union – the special nature of the British constitution, and particularly of the English system of party politics, makes the public choice approach inappropriate for the analysis of regulation in Britain. The simplistic public choice approach – characteristically developed for the American political system – fails to account for the special nature of the UK political system. As was stated above, the UK has a political system, which is centred more on the Party than on individual politicians: party discipline is strict and the scope for politicians to be 'bought' by private interest groups is thus likely to be more limited. Also, the UK has stricter rules (at least on paper[115]) to regulate the acceptance, by politicians, of pecuniary and other benefits and gifts. In consequence, regulation in the UK has thus tended to be symbolic in character and has traditionally emerged through political responses to well publicized scandals rather than in response to private interest demands (Goodhart 1989; Blundell 1994; Booker 1995).

6. Conclusion: Public Choice Theory

The public interest theory of welfare economics provides an explanation for the interests served by regulation which evokes a conception of altruistic public servants. From this premise, the public interest theory is able to characterize regulation as being an activity directed at the correction of market imperfections in the pursuance of Pareto improvements in market efficiency; in other words in pursuance of improvements in societal welfare and in order to secure the public interest.

The public choice theory on the other hand advances an entirely different explanation. Public choice rejects the public interest theory's evocation of altruism as a motivational theory for the behaviour of policy-makers as being unrealistic, theoretically without foundation and also contradictory to most of the empirical evidence on regulation. In its place, the public choice theory puts self-interest; policy-makers, regulators and the like will pursue actions coterminous with their individual self-interest as utility-maximizing agents.

Although, as Levine and Forrence argue, the public interest theory "...was dominant for many years, then left dead by academics in the 1960s and 1970s," the alternative, the public choice theory of regulation has also been subjected to

[115] Especially since the Nolan Committee recommendations were implemented in 1996.

considerable criticism in recent years, most notably from the political sciences (Meier 1985; Wilson 1980; Moran 1986) and from economics (Friend 1984; Horwitz 1989; Goodhart 1989). Whilst some criticisms of the simplistic public choice approach of Stigler are undoubtedly valid, public choice remains a powerful theoretical approach for explaining the interests served by regulatory phenomena; especially as the theory has become more developed.

The more developed version of public choice recognizes the possibility that regulators and politicians may serve some conception of the 'public interest'[116]. A number of extensions and modifications have been made to the private interest theory since Peltzman. Most significantly, the role of the regulator to pursue personal agenda has been given greater weight (Levine and Forrence 1990; Bernstein 1955), the role of determined politicians to originate regulation has been recognized (Calomiris and White 1994) and the power of non-commercial consumer groups to originate regulation has also been taken on board (Blundell 1994). The dynamics of the regulation-seeking process have been examined, and have resulted in a greater emphasis on attempting to understand how competition among industry sub-groups to benefit at the expense of other sub-groups works (Becker 1983; McChesney 1987). There has also been a recognition that much regulation is symbolic in nature (building on the work of Edelman 1964) and that regulation often emerges as a result of a complex coalition among consumer groups, politicians and private interests (Yandle 1983).

It has also been claimed (Goodhart 1995; Black 1997) that the public choice approach to regulation is not valid for the UK. However, although it may be true that the UK political system makes the buying of regulation by private interests less likely (or at least less likely to be clearly visible), there is nothing in the UK political system which precludes the influence of private interests on regulatory policy and on the design of regulatory instruments and institutions.

A public choice approach can be crystallized in the following series of logical propositions:

1. Regulation is one manifestation of the coercive power of the state and is a

[116] Engage in on-the-job consumption of ideological benefits (Kalt and Zupan 1984, 1990).

resource or threat to every group/ sector/ individual.

2. Groups/ sectors/ individuals will compete for protective or beneficial regulation from the state.

3. Policy makers are self-interested and their self-interest may not always be coterminous with their official 'public interest' regulatory raison d'être (although it may be).

4. If the mechanisms of control (e.g. control by constituents on MPs, control by Parliament on the Executive, control of the Executive over senior regulators, control by regulators over junior - operational level - regulators) are insufficiently strong to prevent the agent (the regulator) from pursuing self-interested behaviour then regulators may choose to satiate the regulatory demands of private interest groups in return for 'benefits in kind' (regulatory slack may also allow regulators to pursue personal agendas and moral crusades).

5. The interest groups most able to provide the kind of benefits that may be attractive to regulators/ policy-makers are from industry. They can provide jobs in the industry, popularity, money, travel etc. Industry is also more organized whereas ordinary individuals (consumer groups) are not.

6. Evidence of the influence of private interests will be evident in regulatory policy which, ceteris paribus, serves the interests of private interests or which fails to achieve the supposed public interest objectives.

The next chapter articulates the philsophical basis and methodology for this study of the interests served by the FSA.

CHAPTER THREE

Methods and Methodology

1. Introduction

A Ph.D. indicates that the holder has a command of his or her field and has made worthwhile contributions to it.[117] The contributions of this thesis can be divided into three main categories.

- Those related to the application of a public choice analytical framework to a case study of British government regulation.

- Those related to the comparing of the practical adequacy of the public interest and public choice theories of regulation.

- Those related to the case study itself, which develops a greater understanding of the origins, development, effects, and interests served by the FSA.

In addition to the above contributions, the thesis also evaluates the new Financial Services and Markets Bill (FSMB) in the light of the research findings.

This chapter focuses on methodology and the philosophical basis to the study. There are three main elements to this: (i) the ontological assumptions for the study; (ii) the epistemological assumptions for the study; and (iii) the methodology adopted and the methods chosen. This chapter considers each of these in turn, beginning with the ontological assumptions. This chapter also highlights the interdisciplinary nature of the study; the relationship of the study to other disciplines is also examined. Finally, the philosophical and methodological assumptions, and the choice of methods are defended.

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[117] Phillips, E. and Pugh, D. (1994) How to get a PhD: A Handbook for students and their supervisors. (Open University Press).

2. Philosophical Basis: Ontology and Epistemology

Ontological Assumptions

The study adopts a realist ontological stance: A real world exists independently of our knowledge of it. Solipsism and similar philosophies, whilst logically irrefutable, can be dismissed on the grounds that they ultimately reveal themselves to be "indefensible over-elaboration's of realism"[118]. Within the limitations of our sense perceptions, knowledge of reality is possible. Our criterion or test of reality is that "real entities behave in a complex and autonomous way... if something 'kicks back', it exists. Scientific reasoning, which uses observation not as a basis for extrapolation but to distinguish between otherwise equally good explanations, can give us genuine knowledge about reality".[119]

Epistemological Assumptions

Epistemology, or the 'theory of knowledge', is the branch of philosophy concerned with the nature of knowledge, its scope, general basis and possibility. Is it possible for us to obtain knowledge of reality? If it is possible, to what extent can we know reality? Finally, by what methods can we 'know' reality? And how reliable are these knowledge claims?

Positivism

Until quite recently, a positivistic epistemology has been dominant in the social sciences. Positivism (or logical positivism), which is still largely dominant in the natural sciences, is an extreme form of instrumentalism (i.e. the view that theories are merely instruments for making predictions). It holds that "all statements other than those describing or predicting observations are meaningless."[120] To be capable of verification by observation (experimentation), theories must make testable predictions. A theory-neutral observational language can then test these predictions. Theories that are incapable of empirical testing are therefore rejected as being metaphysical and unscientific. However, by rejecting the metaphysical, positivism rejects the "...very knowledge of subject/ object relationships on which any epistemology, including its own, is ultimately grounded."[121] Positivism thus rejects

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[118] Deutsch, D. (1997) *The Fabric of Reality*, (London: Penguin), p.97.
[119] Ibid.

the foundations of its own grounds for warranted knowledge. It can therefore be rejected as internally inconsistent and incoherent.

The study does not adopt either the positivistic approach or the falsificationalist approach of Popper[122]. For, whilst reality is not immune to empirical check, our knowledge of it is fallible and theory laden. Neither the concepts of truth nor falsity provide "...a coherent view of the relationship between knowledge and its object."[123] Two factors render the proving or falsifying of theories impossible. First, is the *problem of induction.*

Induction and the Problem of Induction

Induction is the process whereby general theories are supposedly obtained from observation, and justified by subsequent observation. The *problem of induction* refers to the inability to infer general rules from observation. This is because future observations/ findings may render a theory/ hypothesis false. Thus, for example it was (falsely) accepted as true that *all* swans are white, *until* black swans were observed in Australia.

Another example is that of Bertrand Russell's farmyard chickens. According to inductivists, the chickens in the farmyard are supposed to extrapolate from repeated observations to conclude that the farmer will continue to feed them. One day, the farmer comes and wrings the chickens' necks. As Deutsch comments "This

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120 Deutsch, D. (1997) *op. cit.* p.30.

121 Johnson, P. and Gill, J. (1991) *Research Methods for Managers.* (Paul Chapman Publishing), p.133.

122 In contrast to Popper's normative view of science (i.e. that scientific discovery ought to have the characteristics of open and logical criticizm of rival theories), Thomas Kuhn, in his influential book of 1971 The Logic of Scientific Discovery advanced an alternative epistemology. Kuhn argued that there can be no *logic* of scientific discovery, only a *sociopsychology of discovery* (Nachmias et al, 1997); science abounds with inconsistencies and anomalies and it is culture, tradition and social norms that play a more important role than reason in scientific discovery. Kuhn argued that science could exist in two different states at different times. *Normal science* represents the accepted wisdom of the scientific establishment. The scientific establishment, in stark contrast to Popper's theory, does not challenge or seek to falsify its theories. According to Kuhn, a paradigm exists which secures certain puzzle-solving attributes and any challenge to it is resisted. Scientists have a commitment to a particular paradigm (for example the Newtonian 'classical' view of physics or the geocentric view of the cosmos) and they defend this vehemently from attack. However, occasionally a new paradigm is advanced which overthrows and replaces the established paradigm: this is *revolutionary science* (Two good examples are Einstein's replacement of classical physics with our current paradigm based on relativity and Copernicus's and Newton's replacement of the geocentric theory of the cosmos with the heliocentric model). In certain circumstances the new paradigm may replace the old paradigm and become the *accepted wisdom.*

123 Sayer, A. (1997) *Method in Social Science: A Realist Approach,* (London: Routledge). p.5.

inductively justifies the conclusion that induction cannot justify any conclusions!"[124] A theory can never be justified by repeated observations, as future observations may render it false.

Whilst, the above examples demonstrate that it is not possible to justify theories by repeated observations, there is also a more fundamental criticism. This is that it is not possible to form new theories from the inductive extrapolation of observations. As Deutsch states "...it is impossible to extrapolate observations unless one has already placed them within an explanatory framework."[125] In the case of Russell's chickens, in order for the chickens to form their theory that the farmer would return to feed them every day, they must first have theorized on the motivations behind the farmer's behaviour. If the chickens had first theorized that the farmer was fattening them up for slaughter then they would have extrapolated, and interpreted his behaviour somewhat differently. An increase in food would have sent out serious warning signals that slaughter was imminent. However, if they had first theorized that the farmer was a benevolent keeper, then an increase in food rations would simply have confirmed that the farmer's benevolence had increased. Thus, the same empirical observations lead to conclusions which are diametrically opposed depending on the prior theory adopted. It is thus impossible to justify either theory in this manner. New theories cannot arise through induction.

Karl Popper and Falisificationalism

Sir Karl Popper claimed to have solved the problem of induction by advancing a falsificationalist methodology that made use of the valid deductive form of inference. This is often termed the hypothetico-deductive method.

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[124] Deutsch, D. (1997), *op. cit.* p.60.
[125] *Ibid.* p.61.

Figure 2. The Hypothetico-Deductive methodology.

Theory/ Hypothesis Formulation

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Operationalisation - translation of abstract concepts into indicators or measures that enable observations to be made

↓

Testing of theory through observation of the empirical world

↓	↓
Falsifying and discarding theory	Creation of as yet unfalsified covering laws that explain the past and predict future observations

Popper argued that whilst theories could not be verified as true, they could be rejected as false. He argued that whilst observations in support of a theory do not verify its truth, observations that disprove or 'falsify' a theory's conclusions, necessarily falsify the premises and thus allow us to reject the theory as false. As Popper states,

> It thus leads, almost by necessity, to the realisation that our attempts to see and to find the truth are not final, but open to improvement; that our knowledge, our doctrine, is conjectural; that it consists of guesses, of hypotheses, rather than of final and certain truths; and that criticism and critical discussion are our only means of getting nearer to the truth. It thus leads to the tradition of bold conjectures and of free criticism, which created the rational or scientific attitude.[126]

However, Popper's falsificationalism does not solve the problem of induction. As a matter of semantics, not using induction does not amount to a solution to it. If all events are contingent and vulnerable to change (the 'big problem of induction') "what may be falsified today may be corroborated tomorrow."[127] Thus, the fact of a falsifying observation today does not lead to the conclusion that a repetition of the test will yield further falsifications. As Sayer concludes, "If all events are contingently related, falsifications are of no great significance and conjectures about universal

[126] Popper, K. in Miller, D. (editor) (1983), *Pocket Popper*, (Fontana), p. 29.
[127] Sayer, A. (1997), *op. cit.*, p. 171.

regularities are not bold but foolish."[128] It is only if there is a pre-supposition that some relations are 'necessary' that falsifications can be taken to have any significance; thus, Popper presupposes what he claims to deny.

The second barrier to our obtaining knowledge of reality is the impossibility of objective theory-neutral observation. Positivists argue that the researcher can observe the world directly and objectively. They assume a subject-object dualism that allows the separation of the subject (the researcher) and the object (the observed phenomenon). This separation is achieved by the application of strict, scientific methods. It is thus possible "by using rigorous methodology...to have knowledge that is independent of the observer and uncontaminated by the very act of observation."[129] The researcher can thus enjoy a direct, 'correspondence' relationship with reality.

However, the process of knowledge creation is a social phenomenon and a whole range of factors may influence observations. First, the very process of perception is subjective. An overwhelming array of sensory data constantly bombards the senses. In order to manage this sensory data we make judgements (mostly subconscious) to categorize and order the data; we emphasize, de-emphasize and filter sensory data by our cognitive processing mechanisms.

Second, it is the theoretical and conceptual lenses that we wear that determine what we observe. Observation is theory-laden. We attempt to order and make sense of sensory data by using concepts and theories. However, different observers utilise different conceptual frameworks and different theoretical 'lenses'. We are therefore not passive observers. Our subjective (and often subconscious) analytical apparatus determine our perceptions of the world.

If it is not possible to prove or falsify theories (other than those which are logically deduced analytically or relate to mathematical axioms) what is the philosophical basis for conducting research? This leads to the question as to whether empirical research, as many relativists have argued, ought to be rejected all together? I think not. Indeed, relativism itself is self-refuting, for if all theories are equally true then anti-relativism must be true also!

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128 Ibid.
129 Gill, J. and Johnson, P. (1997), *op. cit.*, p.132.

Critical Realism

All observation is theory-laden. All observation is made through our available conceptual frameworks/ lenses. However, our conceptual frameworks do not determine the structure of reality, which exists independently of our existence. Despite our inability to have a correspondence relationship with reality, it *is* possible to differentiate between different theories or paradigms of the world on the basis of their *practical adequacy*. Truth is "...neither absolute nor purely conventional and relative, but a matter of practical adequacy."[130] Sayer (1997) identifies five ways in which knowledge develops:

1. The discovery of further instances of objects which are deemed to be already satisfactorily conceptualized.
2. When the displacement of an existing concept to a new situation actually changes its meaning.
3. After the discovery of the failure of expectations that are generated by existing knowledge. Discoveries of practical-inadequacy can identify problems concerning either what we think of as 'observational statements' or what we think of as 'theoretical' claims or assumptions.
4. After the discovery of inconsistencies and contradictions between concepts upon theoretical reflection on the conceptual system. This may lead to changes being made to concepts or whole systems.[131]

[130] Sayer, A. (1997), *op. cit.*, p.84.

[131] Lakatos argued that there exist two elements to a research program, an invariable *hard core* and a variable *protective belt*. Changes to the protective belt represent minor modifications to the research programme. However, changes to the hard core represent paradigm shifts. In economics, rational choice, stable preference, and equilibrium structures of interaction have formed the basis of the hard core of the micro-economic paradigm over the 20th century. The developments to economics from law and economics, New Institutional Economics and Transactions Costs Economics, and others, have represented changes to the protective belt of the micro-economic neo-classical paradigm. Problems with the paradigm are addressed with modifications/ improvements to the protective belt.

Knowledge is evaluated in terms of "...how successfully it may guide action towards the realization of particular objectives which are the expressions of particular interests or needs....[R]esearchers should therefore accept their role as that of partisan participant in interest-laden dispute and divest themselves of allusions to the role of detached observer...occupying a neutral position."[132]

The Public Interest and Public Choice paradigms

The study considers the case (the FSA) from two rival perspectives/ paradigms/ conceptual systems (Lakatos 1970; Kuhn 1970; Barnes 1982)[133]. The dominant paradigm in financial regulation has been the public interest paradigm. This views regulation as being a response to market imperfections. The idealised model of general competitive equilibrium of neo-classical economics is set as the benchmark. When empirical markets are found imperfect against this benchmark, regulatory intervention is advocated. Regulatory instruments are then targeted at correcting the market imperfections and improving market efficiency. The task of carrying out regulation is considered unproblematic.

This view of regulatory activity has been termed 'the public interest theory of regulation'. Regulation is utilised in order to correct market imperfections (which, by impairing market efficiency must impair the public interest) and is implemented by altruistic non-self-interested regulators. If the public interest 'paradigm' were a 'true' (practically adequate) description of the operation of the FSA then one would expect to see the investor being served by regulation - regulatory policy and the enforcement of policy. The study will consider whether this has happened – is the public interest paradigm a practically adequate explanation for the interests served by regulation?

The public choice framework represents the application of economics (with the paradigmatic assumptions of the rational, utility maximising self-interested individual) to the field of public policy. It suggests that regulators, bureaucrats and politicians will behave the same in their public sphere as they do in the economic sphere; namely, they will seek to promote their own interests. They will not, public choice argues, serve the public interest (whatever this may be) altruistically but will serve their private interests. The public choice approach thus suggests considering the

[132] Gill, J. and Johnson, P. (1997), *op. cit.*, p.139.
[133] The study is approached from a realist perspective.

private interests of individuals and groups as a predictor/ tool for analysing group and individual actions. This approach will be utilised to analyse and interpret regulatory policy and used to explain the interests served by regulation in terms of regulatory outcomes.

3. Methodology

<u>The Case Study Approach</u>

The thesis applies a case study approach to a public policy analysis of the FSA. The case study approach adopted is from Yin (1989, 1993) and is firmly rooted in the explanatory[134] case study model[135]. The use of the case study approach has a rich heritage in the public choice field, and particularly with regard to investigations into the political economy of Government regulation (Horwitz, 1989). The theoretical propositions (informed by the public interest and public choice paradigms) determine the design of the empirical study. The study makes use of qualitative data as opposed to hard empirical statistical tests. The field of study necessitates this approach. The area is complex and the effects of regulation are diverse and nebulous: thus the use of formal statistical tests is either not possible or, at best very limited. In any case, 'hard' data are notoriously lacking. A range of secondary data sources are utilised including newspapers, the trade press, consultancy reports, consumer group research, research conducted by the regulatory bodies and by the OFT. The study also makes use of original empirical data gathered in a series of semi-structured interviews with senior industry figures, consumerists, policy-makers and trade association heads. Reliability is enhanced by utilizing a variety of corroborating data sources[136].

The study utilizes a range of secondary information sources including newspaper articles, Parliamentary reports, consultancy reports, consumer reports, industry journals, academic journals, and television/ radio reports.

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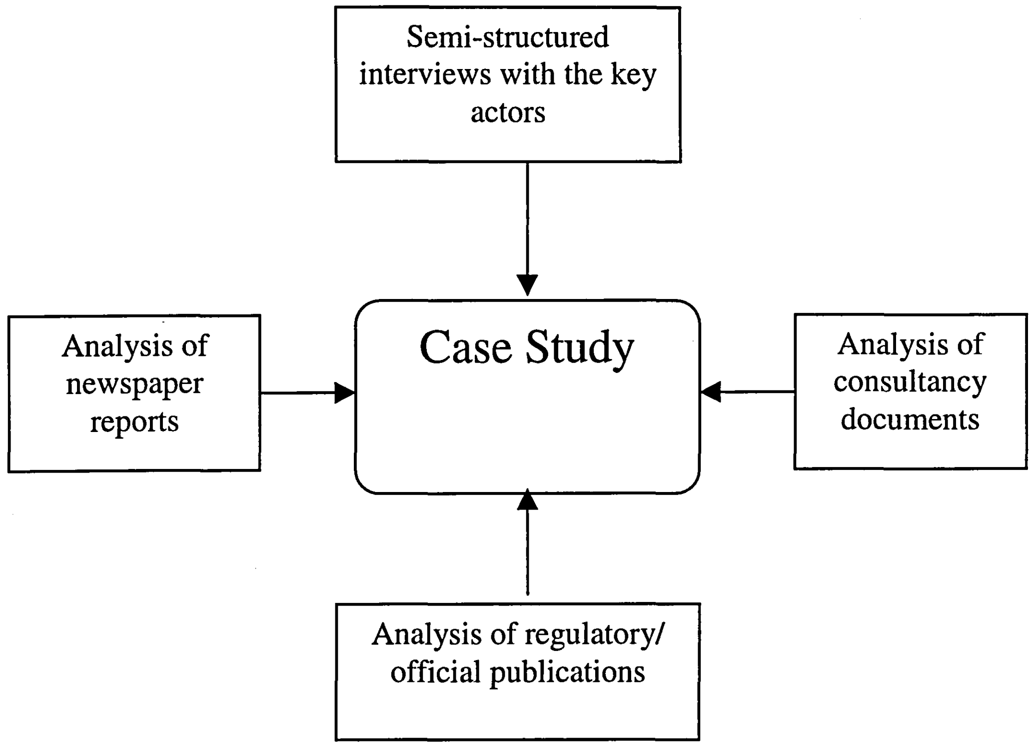
[134] Scapens (1993) identifies five different models for case study research: descriptive studies, illustrative studies, experimental studies, exploratory studies and finally, explanatory studies.

[135] Yin, R.K. (1989) *Case Study Research: Design and Methods,* (London: Sage); and Yin, R.K. (1993) *Applications of Case Study Research,* (London: Sage).

Figure 3. Case Study Data Sources.



The sources outlined above in Figure 3. yielded a wealth of data on the origins, development, effects and interests served by the FSA. However, the publicly available information is inevitably limited in its relevance to the specific research questions. Consequently, I decided to conduct a series of interviews with the relevant actors in the field. The wealth of data that was derived from the interviews represents a major element of the original contribution of the research project. The methodology for the interviews is now outlined.

The Qualitative Research Interview

The interviews were semi-structured[137] and were not preceded by questionnaires. The decision not to conduct questionnaires was based on a number of reasons. First, there

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[136] Accounts are triangulated to increase confidence in their accuracy.

[137] This method lies between the qualitative research interview and the structured interview. It uses an interview schedule which is a format rather like the structured interview, with questions included in a set order. However, many of the questions are open-ended, and there is flexibility to allow variation in the order in which groups of questions are asked. The focus tends to be on factual information and general evaluative comments. The semi-structured method incorporates assumptions of both positivist and humanistic approaches. Structured open response interviews are best when: (i) A quick, descriptive account of a topic is required, without formal hypothesis testing. (ii) Factual information is to be collected, but there is uncertainty about what and how much info participants will be able to

were issues related to the type of data required. The objective was to collect the views, accounts, perceptions and anecdotes of key actors in the domain of study. Senior executives (mostly director level) within companies and the chairmen/ heads of trade associations were thus the people who were targeted. The sampling method for choosing interviewees, was focused on targeting the *key informants*[138] and then utlizing the snowball effect to gain access to other key actors[139]. I decided that questionnaires were unlikely to solicit a response from the kinds of people I was targeting. Given that it was anecdotes, opinions and accounts that were required, I also thought it unlikely that the questionnaire method would yield productive results given the nature and constraints of the structured questionnaire. It was also considered that any responses that *were* forthcoming from a questionnaire would also be significantly more discreet than what could be obtained in verbal interviews[140]. I thus decided to utilise semi-structured, in depth interviews.

Second, there were issues related to resources. Questionnaires are expensive to conduct and take a great deal of time to construct, pilot, distribute, receive replies and then analyse. Given that the results were not expected to be of significant value, I decided that the expense of conducting a questionnaire was not justified; the costs outweighed the benefit.

A final and related issue is that of the urgency of completing the study. I designed an initial research strategy based on the promise of collaboration with another university best not named. The collaboration was to provide a large body of survey data – the Evolution Project questionnaire and results – in fact that was to form the empirical basis of the study, and it did not become clear until mid 1997 that the other institution had lost interest in the collaboration. A new source of empirical

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provide; (iii) The nature and range of the participants' likely opinions about the research topic are not well known in advance, and cannot easily be quantified.

[138] The choice of who were key informants was informed by the theoretical propositions and by the other sources of evidence.

[139] Given that my focus of interest was in issues of government/ regulatory policy, corporate strategy, the behaviour of policy makers and the industry, and in the opinions of top level industry executives, thus access to 'key actors' was clearly a critical problem. Some people (important 'players') refused my requests for interviews and this must, inevitably weaken the study. However, a great deal of effort was expended on securing access to as many of the key actors as possible, and using other sources (where possible) to make up for those missing accounts.

[140] The decision was taken to tape the interviews, where permission was forthcoming. There are clear implications of this for the likely behaviour of the interviewees. In general one would expect interviewees to be more guarded when being recorded. However, whilst recording them may have had some costs in terms of interviewees being more discreet (although there is little evidence of this),

material was therefore needed in a hurry, and it was decided that semi-structured interviews with key industry actors, consumerists, policy-makers and trade association figures were the most appropriate method of obtaining this data in the time left.

I drafted an interview schedule in August/ September 1997. The interview schedule was structured around the research questions, which relate to the interests served by regulation. Four key informants were then contacted: Phil Telford (Senior Researcher Consumers' Association), Gary Heath (CEO of the IFA Association), Mark Boleat (Director General of the ABI) and John Ellis (Ex DTI, MIBOC, Lautro civil servant/ executive and now director of the LIA). From these interviews, a further series of informants emerged, including four consumerists, five bancassurers, ten IFAs, ten Life offices and twelve policy makers. I received replies from three consumerists[141], four bancassurers[142], five IFAs[143], seven life offices[144] and two policy makers[145]. A further series of interviews were then conducted. Out of these, a further number of key informants emerged including four IFAs and two policy-makers. Further interviews were then conducted.

The total interview sample was, in total twenty-five subjects[146]. Although this is a relatively small number compared to the kind of sample that might be undertaken in a major questionnaire survey, the depth of the interviews, combined with the 'key informant' characteristics of most of the interviewees (most were senior managers and directors) suggests that twenty-five subjects was enough to give a representative and balanced sample. The sample was made up of the following people (note that

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I considered that the benefits of having the interviews on tape (and thus not losing/ forgetting comments) outweighed these potential costs.

141 No reply was received from the Low Pay Unit despite a reminder letter being sent.

142 No reply was received from Lloyds-TSB or from Abbey National.

143 Countrywide IFA Network replied but turned down the request for an interview, Dr Thomas, of Thomas Financial Planning declined the request, and there was no reply forthcoming from Hogg Robinson, IFA Promotion, N.J. Leeson and Co. and Sheffield Insurance Services Ltd.

144 Standard Life replied but no interview was carried out due to the location being in Edinburgh and the high cost of travelling and staying there; no reply was received from Pearl Assurance, Skandia Life, Royal Sun Alliance and Brittanic Assurance.

145 Lord Tebbit, Lord Lawson and Michael Blair declined the request for an interview, No reply was received from Sir Mark Weinberg, Sir Kenneth Berrill, David Llewellyn, Sir Godfrey Jennings, Howard Davies, Collete Bowe or Kelvyn Baynton (although an interview was conducted with Mr Kelvyn Baynton in the summer of 1997 in relation to the PIA's Evolution Project).

146 Gary Heath and Phil Telford were interviewed twice. John Ellis was also interviewed twice but excessive noise in the interview location (the Institute of Directors, The Mall) on the second occasion prevented me from transcribing it.

interviewees were drawn from a wide cross section of industry, consumer groups and policy makers):

IFAs

Steve French – IFA with Haynes-Watts Chartered Accountants (15/5/98)

Robert Reaney – IFA with Haynes-Watts Chartered Accountants (23/4/98)

Gary Heath – CEO of IFA Association (24/11/97 and 8/4/98)

Nick Ansell – CEO of IFA Network (19/3/98)

Ken Davy – Chairman of DBS (23/3/98)

Ian Bradshaw – Bolsterstones Financial Advice (26/3/98)

Chris Davidson – Compliance Manager, Bradford and Bingley (12/3/98)

Intermediaries

Michael Abrahams – Compliance Director, Barclays Life (26/1/98)

Michael Drakeford – Midland UK, Compliance Manager (19/2/98)

Joanne Hindle – Head of Pensions, Nat West Life (7/1/98)

Arthur Selman – Compliance Manager, Halifax Life (24/2/98)

Consumerists

Phil Telford – Senior Researcher, Consumers' Association[147] (11/2/97 AND 9/6/98)

Barbara Saunders – Chair of PIA Consumer Panel (31/3/98)

Harriet Hall – Senior researcher at National Consumer Council (11/2/98)

Life Offices

Laurie Edmans – Deputy Chief Executive of NPI (27/2/98)

Mark Boleat – Director General Association of British Insurers (26/11/97)

Karl Snowden – Public Affairs Director Allied Dunbar (3/3/98)

Nick Johnson – Compliance Manager, General Accident Life (28/1/98)

Geoff Walker – Compliance Manager, Virgin Direct (12/2/98)

Andy Purvis – Compliance Manager, Sun Life (2/2/98)

Dianne Powell – Compliance officer, Prudential (5/3/98)

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[147] Also interviewed in January 1996, along with Professor Michael Moran and Professor Charles Goodhart.

Policy Makers

John Ellis – DTI, MIBOC Civil servant, Lautro executive, now LIA director (11/12/97 and 19/3/98)

Michael Howard – DTI minister (6/4/98)

Kelvyn Baynton – Head of Public Affairs, PIA[148] (14/8/97)

Isaac Alfon – SIB Cost-benefit analysis (14/10/97)

The interviews lasted between half an hour (for Michael Howard) and two and a half-hours (for Karl Snowden and Phil Telford 2). The mean interview length was a little over an hour.

The Interview Schedules

An interview schedule was designed which focused on the main areas of interest. A slightly different schedule was designed for the different groups, for instance the schedule for industry groups included questions on the impact of regulation on their business, on their sector and other sectors of the industry. The schedules were not intended as (or used) as rigid scripts. The knowledge and experiences of the interviewees was unclear a priori, they were thus allowed considerable flexibility in what they talked about. To some extent, I allowed the interviewees a level of control over the direction of the interview; the interest was in the interviewee's account.

The different interview schedule outlines are set out below:

(a) Interview schedule for industry

1. The regulators/ policy making/ consultation.
2. Background – MIBOC/ SIB.
3. Rules – polarization, disclosure, best advice.
4. Regulators
5. Impact on industry
6. Impact on the investor
7. Scandals

[148] Interviewed Summer 1997.

(b) Consumerists

1. Rationale for regulation/ protection against what?
2. The regulators – policy/ consumer influence.
3. Level of protection delivered by FSA.
4. Perverse effects of regulation on the investor.
5. Scandals.

(c) Policy makers

1. Objectives of regulation.
2. Gower/ FSB/ FSA.
3. The effects of regulation on the industry.
4. The effects of regulation on the investor.
5. The regulators.
6. Rules – training and competency, disclosure.

Interview Analysis

The process of analysing the interviews involved the following stages:

- Transcribing the interviews. On average a one hour interview took six hours to transcribe. The total length of interviews was approximately twenty-six hours, making a total transcribing time of one hundred and fifty-six hours, or a little under three weeks of work. The total length of transcriptions was approximately 230,000 words.

- Breaking the interviews into the five group categories: IFAs, Bancassurers, Life Offices, Policy-makers, and Consumerists.

- Breaking the individual interviews into categories [(1) Pre FSA, (2) Background, (3) The Regulators, (4) the Industry, (5) Rules and Regulation, (6) 'Scandals', (7) The Investor], sub-categories (For example, in the case of main category 1, Pre FSA, the sub-catogories are 1.State of law, 2. Recruitment and Training practices

3. Selling Practices) and themes (more specific classes of comments from the interviewees, such as the citing of lax rules enforcement for example).

- Drawing out themes that emerged from the five groups: IFAs, Bancassurers, Life Offices, Policy-makers and Consumerists.

- Drawing out themes from the whole sample – common themes within specific categories and sub-categories.

- Reflexively considering the emerging themes against the research questions (especially against the public interest and private interest paradigms).

CATEGORIES
(A) PRE FSA MARKET
1. STATE OF LAW
2. RECRUITMENT PRACTICES
3. SELLING PRACTICES

CATEGORIES
(B) BACKGROUND
1. RATIONALE FOR REGULATION
2. PROFESSOR GOWER
3. FINANCIAL SERVICES BILL/ ACT

CATEGORIES
(C) REGULATORY BODIES
1. SIB
2. SIBRO
3. MIBOC
4. FIMBRA
5. LAUTRO
6. PIA

CATEGORIES
(D) INDUSTRY
1. IFAS
2. LIFE OFFICES
3. BANCASSURERS
4. APPOINTED REPRESENTATIVES
5. DIRECT SALESFORCES

CATEGORIES
(E) RULES AND REGULATION
1. TRAINING AND COMPETENCE
2. DISCLOSURE
3. CONSUMER EDUCATION
4. ENFORCEMENT OF RULES
5. CONSULTATION
6. POLARIZATION

CATEGORIES
(F) SCANDALS
1. PERSONAL PENSIONS
2. OTHER SCANDALS
3. SCANDAL RESOLUTION
4. GENERAL SELLING PRACTICES
5. CAUSES OF SCANDALS

CATEGORIES
(G) THE INVESTOR
1. COMMISSIONS
2. MORAL HAZARD
3. EDUCATION
4. ABILITY TO MAKE CHOICES
5. PROTECTION AGAINST WHAT?
6. LEVEL OF PROTECTION
7. LOW INCOME CONSUMERS

The themes that emerged from the interviews combined with secondary evidence to provide the material and themes for the case study. Every effort was made to avoid bias in the analysis of the interviews and to present a representative picture of the interviews

4. Relationship to Involved and Related Disciplines

The thesis is interdisciplinary in nature and the methodological locus is nebulous. Whilst it is fundamentally a study in public policy it also encompasses a myriad of other disciplinary areas, including law, economics, financial services, accountancy and political science. I shall therefore now consider the ways in which the study relates to these other disciplines.

Institutional Financial Economics

Public choice is the application of economics to the study of politics. The assumptions of neo-classical economics (rationality, the market and self-interest) are thus inherent in the public choice framework. Actors are considered to be self-interested, rational and utility maximizing. It is recognised that these assumptions are theoretical abstractions necessary for model building. However, it is also recognised that as such they do not represent or explain (entirely) the reality of actors' motivations or actions. It is also recognised that the assumptions of neo-classical economics have been challenged, however it is not the objective of the thesis to consider the theoretical or practical validity of the assumptions. The aim of the thesis is not to defend the public choice theoretical approach as such, but to apply it.

The thesis contributes to the financial economics literature by contributing generally to the literature on financial regulation and secondly to the literature on the FSA. In terms of the literature on financial regulation, the thesis represents a comprehensive study of the origins, development, effects and interests served by a major example of financial regulation. It documents regulatory failure and presents evidence as to the causes of this failure. The study also contributes by exposing the flaws in the public interest explanation for regulation and by the application of a public choice approach to regulation.

The thesis contributes to the literature on the FSA in four respects. First, it contributes to a greater understanding to the origins of regulation, but unlike Moran

(1991), Clarke (1986), Weinberg (1988) or Black (1997), it considers the origins from the rival public interest and public choice perspectives. The origins of specific rules are traced to bargaining between private interest groups for regulatory benefits and to the demands of the state for the symbolic benefits derived from regulation.

Second, the thesis contributes to a greater understanding of the development of regulation. However, unlike Jebons (1995) who considers regulation from the perspective of a regulator or Black (1997) who considers regulation from a legal perspective, regulation is assessed from the perspective of the public interest and public choice perspectives of regulation.

Third, the effects of regulation on both industry interest groups and on investors are examined. There has been little academic work focused on the effects of regulation, since virtually all of the research has been conducted by interested parties such as the SIB[149], the PIA[150], the OFT[151], Consumer Groups[152], the PIA Consumer Panel[153] or Trade Associations[154]; with the work carried out on the costs of regulation by the LBS[155] being apparently the only exception to this[156]. The thesis utilises data provided in existing research, combined with original material collected in interviews

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[149] Securities and Investments Board (1990) Training and Competence in the Financial Services Industry; Securities and Investments Board (1992) Retail Regulation Review: Disclosure, Polarization and Standards of Advice, Consultative Paper 60. (London: The Securities and Investments Board); Securities and Investments Board (1992) Retail Regulation Review. A report by Kenneth Clucas on a new SRO for the Retail Sector; Securities and Investments Board (1993) Pensions Transfers: A Report for SIB by KPMG Peat Marwick. (London: Securities and Investments Board. December); Securities and Investments Board (1993) Making the Two Tier System Work, A report by Andrew Large.

[150] PIA (1996) *Life Assurance Disclosure: One Year On*; PIA (1997) *Life Assurance Disclosure: Two Years On;* PIA (1997) Evolution Project, stage two industry responses.

[151] OFT (1987) The Securities Investment Board; OFT (1987) The Financial Intermediaries Managers and Brokers Regulatory Association; OFT (1988) The Life Assurance and Unit Trust Regulatory Organization Parts one and two; OFT (1993) Fair Trading and Life Insurance Savings Products; OFT (1990) The disclosure of information about life assurance products and commissions paid to independent financial advisers; OFT (1990) Regulatory Costs and the Availability of independent financial advice; OFT (1992) Savings and Investments: Consumer Issues. A report to OFT by Jeremy Mitchell and Helena Weisner; OFT (1993) The Marketing and Sale of Investment - Linked Insurance Products.

[152] Consumers' Association (1998) *Disclosure: protecting consumers?*; Consumers' Association (1997) *Disclosure,* Research prepared by NOP; Consumers' Association (1998) *Product Regulation.*

[153] PIA (1996) Consumer Panel Report; PIA (1997) Consumer Panel Report.

[154] The most notable example being: Bannock, G. and Peacock, Professor Sir A. (1995) "The Rationale of Financial Services Regulation: Is the Current Structure Cost-Effective and Working?" *A discussion document funded by IFA Promotion and published by Graham Bannock and Partners Ltd.*

[155] Franks, J.R. and Schaefer, S.M. (1993) *The Costs and Effectiveness of the UK Financial Regulatory System,* (London Business School in association with The City Research Project); Franks, J.R., Schaefer, S.M. and Staunton, M.D. (1996) *The Direct and Compliance Costs of Financial Regulation,* (London Business School in association with The City Research Project).

[156] Although, the LBS work was sponsored by the Corporation of London as part of the City Research Project and so cannot lay claim to be terribly independent.

with industry figures, trade body heads, consumerists and policy-maker to consider the effects of regulation from the public interest and public choice paradigms. The focus is on identifying the interests served by regulation to determine which groups have benefited from it.

Fourth, the recommendations in the FSMB are analysed. I consider whether any lessons have been learned from the experience of the FSA.

Political science

The seminal work in political science on the FSA is that of Moran (1991). Moran considered the *revolution in regulation* from a macro-political perspective and against the context of earlier regulatory reform in America and Japan. He argues that regulatory reform, which has seen the dismantling and then reestablishment of meso-corporatism along American lines[157] was brought about by pressures of two kinds:

- First, from private interests in the form of global financial conglomerates for the harmonization of global financial regulation. He argues that market changes brought about by global pressures, weakened conservative interests and gave power to groups with an interest in reform. The merchant banks and stock-broking firms who had enjoyed predominance in the City were replaced by global insurance, unit trust and retail banking interests.

However, he considers that on their own these groups were unable to bring about reform. He argues that it took a second pressure to bring about reform.

- This second pressure was caused by a series of financial and banking scandals in the 1970s and early 1980s. These had the effect of bringing the prevailing system of cartel-based self-regulation into disrepute. In the past the City had managed to prevent scrutiny from the institutions of democracy.

However, scandals - especially the collapse of Johnson Matthey Bank in 1984 - severely weakened both the defence of self-regulation and the Bank of England. This was critical, as the Bank had traditionally acted as defender and lobbyist for the City

[157] In a codified, juridified and institutionalized form

in Whitehall. Abandoned by the Bank, weakened by scandals and marginalized by new reforming interests, the conservative elements in the City were defeated and the revolutionary elements triumphed.

Moran's analysis of the origins of regulation is a fascinating study of the politics of the revolution in regulation. Whilst also considering these broader issues too, this thesis focuses more specifically on the dynamics of regulation. The origins of specific features of the regime are traced to bargaining between interest groups. A dynamic of rent seeking by industry interests is identified, and the role of the regulators in satiating industry demands is exposed. Once again, the context for the study is the public interest and public choice perspectives on regulation.

Law

This study is concerned with a particular output of political activity, namely government regulation. The Financial Services Act and the regulatory regime created (or at least allowed) by it is legally interesting in a number of ways. The Act didn't confer powers upon a regulatory agency; it gave powers to the Secretary of State who was then given powers within the Act to delegate them to a designated agency. Furthermore, much of the detail of regulation[158] were left to non-governmental, industry dominated bodies such as MIBOC. The regulatory agency that was created was legally anomalous by being a limited company endowed with a statutory role and with statutory powers. Finally, a defining characteristic of the regime was its self-regulatory nature. Self-regulatory bodies were endowed with the power to create and enforce their own rulebooks of 'best practice' on their members.

This study contributes to the legal literature in a number of ways: (i) It presents a case-study into the origins and operation of a complex example of government regulation. (ii) It presents an original account (including accounts by senior civil servants, industry people and politicians who were involved) on the way in which the legislation was constructed in Parliament. Moreover, (iii) it exposes the myriad problems of enforcing and operationalizing complex regulation. Public choice theory, though popular in the law and economics literature, is decidedly out of flavour in the mainstream legal literature. This thesis represents a challenge to this public

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[158] Relating to the rules which would govern the minutiae of regulation.

interest orthodoxy where regulation and government are seen as perfect solutions to market problems.

5. Potential Criticisms and Counters

Methodology

Methodological criticisms arise on three fronts: on the approach to epistemology (these were considered above), on the choice of paradigms, and on the way in which the theory (the paradigms) are applied.

The choice of paradigms for the study is based squarely in the public choice literature. The debate is polarised between the public interest paradigm (regulation serves the public interest) and the public choice paradigm (regulation serves private interests). The public interest paradigm has been attacked as being a straw man, however the paradigm remains in popular use. For instance Llewellyn argues that state regulation can be utilized to correct market failures that would otherwise "...work to the detriment of consumers if market mechanisms were allowed to operate unfettered".[159] The public interest rationale for regulation pervades all governmental material, much consumerist research and much industry policy work. Regulation is viewed as an economic instrument for policy-makers to apply unproblematically to market imperfections and inequities.

The theory is incorporated into the case study by constantly referring to the two paradigms throughout the analysis. Both paradigms make predictions as to the origins, development, effects and interests served by regulation. The public interest paradigm is tested. Did regulation emerge and develop on the basis of the correction of market failures? Did regulation confer benefits on the publicly stated beneficiaries (the consumer)? Did regulators act uninterestedly to serve the public interest? Or, did regulation emerge through a political bargaining process with the intention that regulation would confer benefits on both industry and policy-makers? Did regulation actually confer benefits on the industry and on policy-makers? Did policy-makers pursue their private interests?

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[159] Llewellyn, D. (1986), "The Regulation and Supervision of Financial Institutions" Loughborough University: *Institute of Bankers conference*, p.11.

Methods

Criticisms of the methods arise on three fronts: related to the choice of the case study approach, related to the use of qualitative methods, and related to the use of semi-structured interviews. The choice of qualitative methods and of semi-structured interviews was defended above. My defence of the case study approach is now outlined.

The study is concerned with developing a greater understanding of (1) regulation in general and the interests served by it, and (2) the FSA in particular. The FSA is a major example of public policy and a case study approach allows both a deeper understanding of the case to be developed, and to apply the public interest and public choice paradigms so as to develop a greater understanding of the interests served by regulation. One case study does not allow conclusions to be drawn on regulation in general, as the chosen study may be untypical. However it has innate value in terms of deepening our understanding of a specific example of regulation and, when added to the literature, may allow more general conclusions to be drawn on the interests served by regulation as a phenomenon.

7. Conclusions

This chapter articulates the methodology for the study. The ontological and epistemological assumptions are stated and defended. The choice of the case study methodology is defended and the selection of research methods (including the choice of the interview method) are also defended. In addition, in recognition of the inter-disciplinary nature of the work, the relationship of this research to the related disciplines in law and finance is examined. Finally, the choice of approach, methodology and methods are defended in light of potential criticisms.

The following chapters investigate the interests served by regulation in the context of the Financial Services Act. The practical adequacy of the rival theories *as explanations* for the interests served by regulation is considered. Does the public interest theory provide an explanation for the origins and interests served by the FSA? Or does the public choice theory present the best explanation for the origins and interests served by the FSA?

CHAPTER FOUR

Private Interests and Moral Panics: The Origins of the Financial Services Act Regime

1. Introduction

This chapter considers the "...constellation of organized interests and public authority which produced the revolutionary changes in regulation and market practices experienced in London after 1983"[160]. Three themes are identified:

- The initial commissioning of Professor Gower in July 1981 was a symbolic response on the part of Government, reacting to a series of well-publicized and politically damaging financial scandals that occurred in 1981.

- In the period 1983 – 1984 a further series of scandals occurred that combined with a growing pace of change in the financial services industry to create both political and industry pressure for regulatory reform. It will be argued that there had been widespread hostility towards the prospect of Government 'interference' up until this point. Once the political process was begun of examining the adequacy of prevailing regulatory arrangements, the pace of market change was such that it brought with it a heightened political imperative for reform. At the same time, the collapse of the dominant system of cartel-based self-regulation aroused industry demands for regulatory intervention, especially in respect of the crucial area of commissions controls. The Government's interest in responding to the 'moral panic' created by financial scandals thus combined with industry desire for state intervention in the light of competitive pressures.

- Once the political decision to legislate had been taken[161] and despite the arguments of ostensibly well-intentioned politicians in Parliament that the ordinary investor needed protecting, the task of designing the new regime was

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[160] Moran, M. (1991) The Politics of the Financial Services Revolution, (London: MacMillan), p.1.
[161] And the symbolic benefits of *doing something* were reaped.

substantively handed over to the industry. The extent of the industry's capture of the process of designing the regime was highlighted by the power vested with formal industry dominated committees[162] and in the form of QUANGOs such as MIBOC which were dominated by members of the industry elite.

Before considering the origins of the FSA, I shall conduct a detailed examination of investor protection regulation in place before the FSA. It is commonly asserted that the retail financial services sector was largely unregulated prior to 1988[163], and that caveat emptor was the state of law[164], this is in fact a misrepresentation, as there existed a great many statutory, common law and informal self-regulatory controls.

I shall first outline the considerable legal protections in place by the early 1980s. I shall then focus on the reasons for the Government's decision to legislate.

2. The Regulation of Financial Services Before the FSA

Prior to the reforms of the 1980s, the regulation of the UK financial services industry was characterized by its uneven, largely self-regulatory and predominantly corporatist nature (Gower 1982, 1984, 1988; Reid 1988; Moran 1991; Clarke 1986). Self-regulatory cartels - implicitly if not explicitly supported by the state - ran the London Stock Exchange, the building societies sector and the commodities markets. Insurance brokerage was regulated by a trade association acting under statutory backing. However, the dominance of self-regulatory methods of control in financial services does not imply that there were no formal regulatory controls. There already existed statutorily defined regulatory controls on insurance companies, unit trust companies, investment brokers and dealers, insurance sales by brokers, and banks. There also existed substantial – theoretical - common law protections for investors, not least from the common law principle of *uberrimae fidei*[165] and the law of agency.

In order to establish a context for the analysis of the origins of the FSA, it is helpful to consider the controls mentioned above in some detail. These controls may be broken into a taxonomy based on the following headings:

[162] Such as the Governor's Advisory Group.
[163] Jebens, K. (1997); Weinberg, M. (1985); Consumers' Association (1997, 1998); Moran, M. (1991).
[164] See Reid, M. (1988); Jebens, K. (1996); Moran, M. (1991).
[165] Utmost good faith.

- Statutory Controls.
- Common Law Controls.
- Self-Regulatory Controls.

<u>Statutory Controls</u>

<u>The Regulation of Insurance Companies</u>

The regulation of financial services is hardly novel. State control of insurers began in 1774 with the Life Assurance Act. The Act essentially outlawed the practice of insuring lives or events by people with no interest in the event; in other words using life insurance as a form of gambling. In 1870 there was the Life Assurance Companies Act. This Act followed the collapse of two sizeable life insurance companies, one of which being the Albert Life Insurance Company, which collapsed in 1869. The Life Assurance Companies Act imposed a duty of disclosure on life companies:

> ...[C]ompanies were required to make public such information about their affairs as would enable members of the public and their advisers to make an informed assessment of their financial stability, but were otherwise left free to conduct their business as they saw fit.[166]

This statutory duty of disclosure reflected the common law duty of *uberrimae fidei* established in 1766[167]. The act also required that insurers deposit a sum of money with the court as security against losses[168].

However, in the 1960s a series of scandals occurred. These principally involved the collapse of a series of cut-price motor insurers, most notorious of which involved Dr Emil Savundra's Fire, Auto and Marine. As has often been the case in other fields, the scandals led to significant changes in insurance regulation. The Companies Act of 1967 made two changes:

- The Board of Trade required insurance companies to be authorized.

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166 Page, A. and Ferguson, R. (1992) *Investor Protection,* (London: Weidenfeld and Nicolson), p. 161.

167 Carter v. Boehm (1766) 3 Burr.

- The Board was imbued with increased powers of intervention.

Further scandals, most importantly, the collapse of Vehicle and General in 1971, led to the powers of the (renamed) Department of Trade and Industry being increased further by the Insurance Companies Amendment Act of 1973. Following the failure of the industry to agree on a voluntary scheme, the scandal also led, through the Policyholders Protection Act of 1975, to the establishment of a compensation scheme for investors. The compensation scheme was administered by a Policy Protection Board and, through a levy on insurance companies, covered 90% of any payment due, 90% of future benefits or the payment of 90% of the value of the policy.

By the 1980s important changes had occurred in both the nature of the insurance market and in the regulation of other sectors of the financial services industry. These factors led to the enactment of the Insurance Companies Act in 1982 (ICA), which signalled the final demise of the principle of freedom with disclosure. The ICA had a number of provisions, it established a requirement for the authorization of those wishing to conduct investment business. Moreover, it became a criminal offence (punishable with up to two years imprisonment and/ or unlimited fines) to conduct investment business without authorization to do so. The Act introduced a range of financial regulations on life companies. It also consolidated solvency requirements, which had first been introduced in 1946[169] but were then strengthened in 1981 with the implementation of the Life Establishment Directive. It introduced detailed portfolio regulations related to the matching[170] and localization[171] of assets and to the range of investments that a life office could hold[172]. The ICA also

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[168] Birds. J. (1993)

[169] Through the Assurance Companies Act 1946.

[170] If a life office had holdings of a single currency exceeding 5% of its total liabilities, then it must also hold matching assets to cover at least 80% of its liabilities in that currency.

[171] Localization requires, for instance that assets held to cover liabilities in sterling must be held in the UK.

[172] Life offices were prohibited from investing more than 5% of their long term funds in shares in subordinated companies or loans to such companies or their controllers (Page et al, 1992).

introduced onerous reporting requirements for life companies[173] and also laid down requirements for a new compensation scheme.[174]

The Regulation of Friendly Societies, Unit Trusts and Securities

Friendly Societies were first recognized by statute in 1793. These unincorporated voluntary associations grew rapidly in the 19th century where they were the bed-rock of financial protection for the majority of ordinary people. They provided sickness benefits and retirement benefits and allowed ordinary people to provide for old age, funeral expenses, and the care of 'widows and orphans'. Their scope of activity was necessarily narrow, their role being confined to the "...relief or maintenance of members and their families during sickness, unemployment or retirement and the provision of life insurance."[175] The limited scope of their activities was formalized in 1875 following the Royal Commission on Friendly Societies. Their importance declined during the 20th century as the state took an increasingly interventionist role in welfare provision – beginning with the introduction of the state non-contributory pensions scheme in 1908, followed by the introduction of a contributory scheme in 1925, a graduated pension scheme in 1961 and finally SERPS in 1978.

Similarly to Friendly Societies, unit trusts have been subject to considerable statutory control. The regulation of Friendly Societies was first considered shortly after they were first introduced in 1931[176] by the Stock Exchange. The Stock Exchange sub-committee concluded that state regulation of unit trusts was required, but another inquiry, the Anderson Committee in 1936 rejected state regulation. Yet in 1937 another committee, the Bodkin Committee was established in response to incidents of share pushing[177] and widespread reports that unit trusts were investing in a wide range of dubious investments[178]. The result of the Bodkin Report was the enactment of the Prevention of Fraud (Investments) Act (PF(I) Act) in 1939 which introduced very strict regulations on unit trusts. Unit trusts then became subject to a

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[173] These reporting requirements included having to send annual reports to the DTI, to submit long-term business plans once every five years and to submit abstracts of actuarial investigations of firms' financial positions.

[174] Interestingly, in recognition of potential moral hazard effects of compensation schemes of this kind, there was a provision for the Board to reduce or disregard "...any benefits payable under a long term policy which in the opinion of an independent actuary are excessive." (Page et al, 1992, p.178)

[175] Page, A. and Ferguson, R. (1992), *op. cit.*, p.179.

[176] Experiencing rapid growth from a base in 1931 to having £50m invested in 67 schemes by 1936.

[177] High pressure selling of shares to the public by salesmen – often on a door-to-door basis.

[178] Reputed to include orchards, mushroom farms and piggeries!

regime which required prior authorization and laid down detailed financial and portfolio regulations[179].

The PF(I) Act also introduced controls on the sales of securities to the public. It required that those in the business of dealing in securities be required to be licensed by the DTI unless they were members of a recognized stock exchange or of a recognized association of dealers in securities, or were otherwise exempted. It was designed to regulate fringe operators who were not regulated by the self-regulatory bodies such as the Stock Exchange, the Council for the Securities Industry and the Panel on Take-Overs and Mergers. Brokers regulated by these self-regulatory clubs were excluded from statutory regulation.

The PF(I) Act was amended in the Companies Act of 1947 and further consolidated in 1958 with a few amendments. Despite these frequent tinkerings with the Act, there was widespread belief in its inadequacy. Its scope was considered too limited and the powers vested by it to the DTI were considered too feeble. Furthermore, the exemptions given in the Act to those dealing in securities as *incidental to their primary business* had the unforeseen consequence that most merchant banks, clearing banks and other institutions secured exempted status. It was also becoming clear that status as an exempted dealer was being seen as a 'prized status symbol'[180] with those not securing exemption being seen as less sound operators. Those dealers who called themselves investment advisers as opposed to investment dealers were also excluded from the PF(I)'s purview.

By the 1970s a combination of inherent weaknesses in the Act and the evidence on its flouting, caused the Act to be viewed as inadequate. As Gower states, "The Act increasingly became a totally inadequate regulatory mechanism...This was generally recognized and from time to time the Board (or department) of Trade had tried to do something about it. But it had always been diverted to attend to some more urgent problem."[181]

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[179] For instance unit trusts were limited strictly to investing in securites which were defined narrowly in the act.
[180] Gower, L. (1982), *op. cit.*, pp. 14-16.
[181] Gower, L. (1988), *op. cit.*, p.7.

Regulation of Sales of Retail Financial Services

The selling of insurance was unregulated by statute until the Insurance Brokers (Registration) Act 1977. Until this act became operational on the 1st of December 1981 anyone could quite legally hold themselves out as an insurance broker and sell life assurance products. Of the total of possibly 15,000 insurance salesmen, 9,000 called themselves insurance *brokers.* Insurance brokers distinguished themselves from the other, mainly part time, insurance agents on the grounds that their conduct was subject to variable degrees of regulation by one of four self-regulatory bodies.

The four bodies - the Lloyd's Insurance Brokers Association (LIBA), the Corporation of Insurance Brokers (CIB), the Association of Insurance Brokers (AIB), and the Federation of Insurance Brokers (FIB) - decided in 1975 to establish a single body to represent and regulate all insurance advisers calling themselves insurance brokers. In January of 1976 the four organizations formed the British Insurance Brokers Council (BIBC) which produced a report entitled Consultative Document on the Regulation of Insurance Brokers. With the support of the industry, the report was introduced to Parliament as a Private Member's Bill, and was eventually enacted as the Insurance Brokers' (Registration) Act 1977.

The most important feature of the Act was the provision for the setting up of an Insurance Brokers' Registration Council (IBRC). This industry-dominated council, comprising of seventeen persons (of whom twelve being industry people and five being chosen by the Secretary of State) had widespread powers to regulate the authorization and conduct of insurance brokers. Whilst the Act did not prohibit insurance salesmen describing themselves as insurance advisers or insurance consultants, it did impose considerable controls on those holding themselves out as brokers. First, it required that those wishing to call themselves brokers (and thus register themselves under the Act) must either (a) have carried on business, or have been employed by an insurance broker or full-time agent for at least two companies, or have been employed by an insurance company, for at least five years; or (b) hold a recognized qualification and have carried on business, or been employed as in (a) for at least three years. Sole traders, partnerships and limited companies are required to comply with regulations regarding solvency, clients' accounts, working capital and professional indemnity cover. Whilst limited companies were required to have at least half of their directors registered as insurance brokers and all work conducted by the company is subject to the day-to-day supervision of the registered persons.

A significant element of the Act was the imposition of a code of conduct on those registered as insurance brokers. There are three key principles within this code:

- Insurance brokers are required at all times to conduct their business with *utmost good faith* and *integrity*.

- Insurance brokers are required to do everything to satisfy the insurance needs of their clients and they shall, at all times place the interests of their clients above all other considerations.

- Statements made by or on behalf of insurance brokers when advertising may not be mis-leading.

These key fiduciary principles were supplemented with nineteen examples of their application. The Act also established an Investigating Committee and a Disciplinary Committee within the Council.

General Statutory Provisions against Fraud and Misrepresentation

There also existed statutory protection for those buying insurance in the general consumer protection law. These remedies included those found within the Misrepresentation Act 1967 the Unfair Contract Terms Act 1977 and the Sale of Goods Act 1979.

Common Law Remedies

Whilst there existed statutory control of insurance companies, statutory regulation of the selling and marketing of insurance products and finally general legal statutory remedies for fraudulent or mis-leading sales contracts, there also existed some important common law provisions for the regulation of retail financial services.

Agency

Some of these come under the common law of agency. Agency law deals with relationships between investors and independent investment intermediaries[182]. When the intermediary holds himself out to be acting on the investors behalf then he becomes the agent of the investor. The investor is thus afforded protections associated with the principal-agent relationship. Where the principal-agent relationship exists, the intermediary assumes a number of obligations to the client:

- A duty of *exercising due skill, care and diligence* with a view to securing the best bargains for the client;
- As the principal-agent relationship is one involving trust (the investor puts faith in his adviser), the intermediary thus owes *fiduciary duties* (duties of loyalty) to the client. These duties are:
    - A duty to act at all times in the best interests of the client.
    - A duty of disclosure: the adviser must disclose all material facts to the client.
    - The adviser must not, without express consent of the client:
        - place himself in a position where his duty to the client conflicts with either his own interest or with his duty to other clients;
        - deal as principal with the client;
        - make secret profit, whether or not it is at the expense of the client.

Whilst these duties offer considerable protection to the investor, there are a number of potential limitations to this protection:

- The enforcement of agency law depends entirely on the private initiative of the investor. Consequently, agency law, as a remedy for the wronged investor can

[182] In the pre-FSA market, financial services were principally sold by insurance agents (who tended to be employees or agents of life offices) and by brokers (who tended to hold themselves out as acting on behalf of the investor).

only work if the investor is actually aware that he has been wronged. Furthermore, he must have the means and resolution to pursue a claim through the civil courts;

- The law of agency has failed to be fully recognized in certain contexts within financial services. For instance in stock-broking, an attempt to apply the agent's duty of skill, care and diligence was frustrated in Schweder v. Walton[183]. In this case the court made a distinction between contractual (remunerated) and non-contractual (gratuitous) agency. They took the view that a stockbroker is employed merely to execute (in return for commission) orders given to them and that advice proffered in between orders is gratuitous. Accordingly, such advice need not be formulated with reasonable care as long as it is given *bona fide*. Page et al (1992) argue that this is a narrow and unrealistic interpretation of the stockbroker/ client relationship (i.e. as a series of separate transactions). They conclude by arguing that case law is confused and leaves little guidance as to what precautions a stockbroker should take before giving advice.

- A softening of the duties imposed by agency law has been observed in the life assurance industry. For example it has always been the practice of insurance intermediaries not to disclose commissions paid by the insurance company.[184]

<u>Uberrimae Fidei: 'Utmost Good Faith'</u>

Insurance contracts are the primary example of a class of contracts subject to a special duty of utmost good faith or *uberrimae fidei*[185]. This provision, extends beyond normal contract law where the doctrine of *caveat emptor* applies - let the buyer beware. Under normal contract law it is left to the parties to a contract to take responsibility for any deal that they make. Of course mis-representation is not permitted but mere non-disclosure is not deemed to be misrepresentation[186]. However, insurance is different. Since Carter v. Boehm[187] the special nature of insurance

[183] *Schweder* v. *Walton* (1910), 27 T.L.R. 89.
[184] The non-disclosure of commissions is not without precedent, for instance travel agents have never disclosed commission.
[185] Others are family arrangements and contracts to take shares in public companies.
[186] In the common law of mis-representation "An insurer can avoid an insurance contract if he was induced to enter into it by a mis-representation of fact made by the proposer which was false in a material particular, whether the proposer acted negligently or quite innocently" (Birds, 1993, p.91).
[187] Carter v. Boehm (1766) 3. Burr.

contracts has been recognized and an additional duty of *utmost good faith* has been imposed on both parties to an insurance contract. As Lord Mansfield stated,

> Insurance is a contract upon speculation. The special facts, upon which the contingent chance is to be computed, lie most commonly in the knowledge of the insured only: the under-writer trusts to his representation, and proceeds upon the confidence that he does not keep back any circumstance in his knowledge, to mislead the under-writer into a belief that the circumstance does not exist, and to induce him to estimate the risque as if it did not exist.[188]

In consequence of the special characteristics of the insurance contract, a reciprocal duty of disclosure is imposed on both parties to the contract. This duty imposes a legal and positive duty on all parties to disclose (both accurately and fully) all the facts[189] materially relevant to the specific contract being proposed, whether they are asked for or not. Moreover, the duty is held to apply throughout the contract up to the point at which it is concluded[190], although it does not apply during the life of the contract once it has been concluded[191].

The development of a common law duty of disclosure on insurance contracts is significant. The common law recognized that there are particularly significant market imperfections in the sale of insurance. Moreover, it instituted a powerful remedy in the form of the duty of disclosure inherent in uberrimae fidei.

Negligence

There also existed protection under the tort of negligence. In Hedley Byrne & Co. Ltd. V. Heller & Partners Ltd.[192] a liability for loss incurred as a result of negligent advice given by the professional adviser was established. However, this may be avoided by a disclaimer, provided that it does not break the UCTA 1977. There is also difficulty in distinguishing between bad advice (advice given without *reasonable*

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188 *Ibid.* Lord Mansfield, at 1905.

189 The duty applies to facts and not to matters of opinion. Misstated opinions will only be actionable if they are made in bad faith. Statements by the proposer on matters of health will not be considered statements of fact because the insured is not considered a medical expert (Joel v. Law Union & Crown Insurance Co. (1908) 2. K.B. 863). However, in certain circumstances, for instance in cases where an insured "...has consulted a doctor in more than an ordinary way, the fact of consultation will almost certainly be a material fact requiring to be disclosed" (Birds, 1993, p.91).

190 Since Black King Shipping Corporation v. Massie (The Litsion Pride) (1985) 1. Lloyd's Rep. 437.

191 Although material facts must be disclosed upon renewal of the policy.

192 Hedley Byrne & Co. Ltd. V. Heller & Partners Ltd. (1964), A.C. 465.

care) and *bad results*. Losing money as a result of advice does not imply bad advice. Thus in Stafford V. Conti Commodity Services Ltd.[193] a claim by a client that his brokers gave him bad advice because of his investments' subsequent poor performance.[194] The case was rejected with the judge arguing that "...losses in the ordinary course of things do occur even if proper care is used when one is dealing with the transactions on the commodities futures market."

The Court of Appeal made a similar judgement. In Merrill Lynch Futures Inc. v. York House Trading Ltd.[195] it was observed that futures markets are "...unpredictable, volatile and extremely risky..." places where even experienced people often lose lots of money. Therefore, it was argued that simply making a poor bargain can be no indication of negligence in advice[196].

Theft

There also existed a remedy in the crime of theft. A person is guilty of theft if "...he dishonestly appropriates property belonging to another with the intention of permanently depriving the other of it."[197]

But there is no theft if one deals with property in a manner which has been authorized by the owner but which unbeknownst to him confers some secret benefit upon oneself. Therefore, the controller of a bank or insurance company who makes secret profits for himself out of dealings with the corporate property for which he has authority does not commit theft. Equally, the intermediary who does likewise with the investor's property, does not commit theft.

In order to establish guilt under the Theft Act it is necessary to prove, beyond reasonable doubt, that there has been dishonesty. The jury must be satisfied that:

(1) What the accused did was dishonest according to the ordinary standards of reasonable and honest people.

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[193] *Stafford* V. *Conti Commodity Services Ltd.* (1981) 1 All E.R. 691, per Mocatta J. at p. 698.
[194] Only 10 out of 46 transactions were profitable.
[195] Merrill Lynch Futures Inc. v. York House Trading Ltd. Times, May 24, 1984, C.A.
[196] Although the finding may be different if an investor could point to a series of poor investments in a stable market.
[197] The Theft Act 1968.

(2) That the accused himself must have realized that what he was doing was dishonest by those standards.

Therefore, an adviser accused of dishonesty will be judged on his perception of standards operating within the community at large and *not those of his particular milieu.*

Self-Regulation of Investment Business

Despite the considerable number of statutory and common law provisions in force in the pre-FSA period, self-regulation was the dominant mode of regulation of investment business. Neither the statutory nor common law controls were particularly effective; the statutory provisions (administered by the DTI) and the common law provisions (under the aegis of the individual consumer and the industry to enforce) were largely unenforced.

Agency law, being an example of private law was considered to be unenforceable by ordinary retail investors because of the high costs of going to court. As Gary Heath[198] argued, "...there were a number laws already in place but mainly they were unobtainable for the consumer because you had to have money to get access to the courts and if you even got a judgement the company could go bust and you were left in the lurch. So there, I think there was a need for some extra safeguards." Agency law was historically weak in its application. Gary Heath again: "...agency law said that they should be disclosing commission, the reality is that agency law isn't that strong. I mean estate agents do because they charge a low rate, but insurance brokers never did, for instance, travel agents never did, a number of people who act as agents for clients don't actually disclose – they should do by law but they don't, or they only do so when the client asks (which is another possibility)."

Chris Davidson[199] summarized the perceived weaknesses of agency law. "Everyone just ignored it! There were no mechanisms to enforce it. The DTI did nothing about it, the life offices would say 'well, the broker would act as the agent of the customer when giving advice but he would also act as the agent of the life office in selling', now there are lots of complexities in that, but in law you couldn't have

[198] CEO of the IFA Association, interview 8/4/98.

[199] Compliance manager of the Bradford and Bingley, interview 12/3/98.

actual agency – but it was very fuzzy, nobody really looked at it very clearly." Michael Howard[200] crystallized the problem, "[I]t was widely perceived that although…there were a number of existing remedies, most of them were civil remedies, and they were inadequate."[201]

The existing statutory remedies were considered by some to be equally inadequate. As John Ellis, a senior DTI official at the time commented,

> …we had existing legislation called the Prevention of Fraud (Investments) Act 1958 which never worked really. In fact the previous Act was in 1939 and I don't think that worked either. What we found ourselves with in about 1981 – 1982 were rules about registration which were widely ignored, particularly in the field that we're in – independent financial advice... And certainly unit trusts, in particular, operated without any authorization, or authorization under the legislation was just widely ignored, and they may not even have been aware of it. [202]

The weakness of existing controls meant that despite the encroachment of the state into the regulation of other industries, the investment industry (and especially the City) was able to escape too much intrusion of the state into its affairs. The Bank of England, acting as a Praetorian Guard[203] helped to support the position of the investment industry, in arguing that "...self regulation....[was] the panacea and that it work[ed] only when...left free from any form of Governmental surveillance."[204] As such, traditionally the firms involved in investment business were subject only to loose prudential supervision by a relevant authority[205].

This sort of regulatory arrangement was in reality a set of informal self-regulatory cartels, and the regulatory process was one of negotiation and compromise between the supervisory bodies and the firms they supervised[206]. The maintenance of self regulatory cartels was possible because the investment industry, and especially

[200] Under Secretary of State at the Dti when the FSB went through Parliament, interviewed 6/4/98.
[201] Ibid.
[202] John Ellis, Public Affairs Director of the Life Insurance Association, interview 11/12/97.
[203] Moran, M. (1991).
[204] Gower, L. (1988), *op. cit.*, p.9.
[205] The DTI was responsible for regulating insurance companies under the Insurance Companies Act, insurance brokers under the Insurance Brokers Registration Act and investment advisers under the Prevention of Fraud Investment Act
[206] A prime example of this negotiational approach which the life assurance industry was able to secure special treatment from the DTI in the era of price controls and during the drafting of the Unfair Contract Terms Act.

the City of London was populated by people who were culturally and socially homogeneous and the industry was demarcated into narrow functional divides. Although some attention was paid to the public interest and the consumer, the cartels engaged in a variety of anti-competitive practices, included commission fixing, the restricting of entry and ownership and a range of market sharing arrangements[207]. As Gower himself argues "...self-regulation to most of the City...meant leaving everybody to regulate himself in his own interests subject only to a possible unpublicized reproof from his professional or trade association if he transgressed too blatantly."[208] This system of cartel-based self-regulation survived largely unimpeded into the 1980s.

Having outlined the regulatory controls in place before the FSA, I shall now consider the environmental changes which spurred the Government into considering radical reform of the prevailing regulatory controls.

3. Deregulation, Market Reform and Ideology

Having been substantially shielded from global reforming competitive pressures up until this time, by the early 1980s a number of pressures acted to transform the retail financial services industry; it was characterized by heightened competition, increased levels of innovation, diversification, de-regulation and growth.

Competition in Retail Financial Services

By the early 1980s the UK retail financial services industry was increasingly competitive. Non-UK financial institutions exploited the removal of exchange controls in 1979 and utilized the opportunities provided by rapid advances in information technology to enter the lucrative financial services markets in the UK. Banks, insurance companies and other investment institutions in the UK had previously provided relatively poor standards of service and of products[209]. Poor value home-service insurance products had dominated the retail life assurance market and banks had exploited their oligopoly market position by paying zero interest on current

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[207] The London Stock Exchange epitomized the self-regulatory model; as Anderton argued "...the exchange was a private gentleman's club and not an institution which exists to perform a public service" (Anderton, 1995, p.22).
[208] Gower, L. (1988), *op. cit.*, p.8.

account deposits and by charging high rates of interest on loans to earn substantial endowment effect profits[210]. The entry of foreign institutions, advances in information technology, diversification, innovation and de-regulation all encouraged heightened competitive pressures in the early 1980s.

Increased Innovation in Retail Financial Services Markets

The retail financial services industry became increasingly innovative. From the 1970s onwards, there was a growing proliferation of investment products that were designed to cater for increasingly specific and specialized investor needs. New products were increasingly complex, especially in relation to the charging structures in use. A number of factors drove the trend of innovation, the most important being rapid technological advances, de-regulation, pressures from increasingly sophisticated consumers for more complex and tailored products, volatility in financial markets, political and economic uncertainty and finally competitive pressures on financial institutions to seek competitive advantage from creating niche products and services.

Deregulation of Financial Services Markets

There were also changes in the regulation of financial services. By the early 1980s the regulatory controls (both formal and informal) on the domestic financial services industry were breaking down. By the early 1980s the old self-regulatory cartels that had dominated the financial services industry were beginning to collapse under competitive pressures. The insurance broking cartel was effectively removed with the enactment of the Insurance Brokers (Registration) Act 1977, the stock exchange cartel was under severe threat from the challenge of the Restrictive Practices Court[211] and finally collapsed at 'Big Bang' in October 1986, the insurance industry's cartel which fixed commissions collapsed in January 1983 and the building societies cartel collapsed in 1983.

In addition to the weakening of self-regulation in financial services, there was also a trend towards the removal of formal state controls. A spate of de-regulatory measures occurred in the late 1970s and early 1980s included, critically the removal

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[209] Mintel (1995, 1998), Jebens, K. (1996).
[210] Moran, M. (1986), Goodhart, C. (1989).
[211] The stock exchange cartel was finally removed by the Goodison-Parkinson Agreement in September 1983.

of Exchange Controls in 1979, the de-regulation of the stock-exchange in 1986 after the Goodison-Parkinson Agreement in 1983, the de-regulation of the building society sector,[212] and the de-regulation of pensions.[213] The banking cartel was removed in 1971 and replaced with Competition and Credit Control, but it was the removal of the Corset in July 1980 (which inevitably followed the removal of exchange controls in 1979) that allowed the banks to expand their activities into the housing market and compete for the first time with the building societies. The removal of both formal and informal controls acted as a major boost to competition in the industry.

The Growth in Demand for Financial Services

Finally, the domestic retail financial services industry witnessed profound growth in the period from the late 1970s. In large part this reflected a general, and substantial increase in personal sector wealth over the period. This is illustrated in the table below.

Table 1. Personal Sector Net Wealth (£b)[214]

1971	1981	1986	1989
191.7	806.7	1,484.9	2,352.4

Investment by the personal sector in life assurance, pensions and unit trusts increased dramatically over the period. Between 1976 and 1980 the assets held by the pension funds increased by 311%, the assets held by the insurance companies increased by 180%, and the assets held by the unit trust companies increased by 100%[215]. Between 1992 and 1999, the combined assets of the life assurance and pension companies increased by over 100%[216]. The growth in the demand for financial services is explained by a number of factors. The first of these is the economic and political turmoil of the 1970s encouraged the personal sector to run a considerable surplus.

212 With the eventual enactment of the Building Society Act 1986.
213 With the enactment of the Social Security Act in 1986.
214 The Office for National Statistics. (1993) Social Trends, Vol. 23.
215 Central Statistical Office, Financial Statistics, various issues.
216 The Office for National Statistics. (October 1999), Financial Statistics.

In addition, high rates of inflation (still rising in the early 1980s) encouraged consumers to seek investment mediums that would protect the value of their savings. A further factor was that increasingly sophisticated consumers[217] sought to secure shelters from the punitive tax rates in place in the late 1970s and early 1980s[218]. Pensions and life assurance were particularly tax-efficient, as investment in life assurance and pensions attracted very favourable tax treatment from the Government. Pension funds approved by the Inland Revenue attracted 100% tax relief on both investment earnings and on capital gains on assets and life assurance attracted tax relief until 1984[219].

Several key pillars of Government policy encouraged a growth in the demand for financial services. The first of these was that the Government encouraged, both through its policy of selling off council houses and through favourable tax treatment of mortgages[220], a boom in residential property ownership. In 1980 the proportion of personal sector liabilities represented by mortgage loans was 57%[221], and this increased to a figure of 70% by 1993. Mortgages provide a major source of business for financial services institutions, not only in the actual mortgage loan but in the investment product invariably used to support the loan. Mortgages also provided various opportunities for the cross-selling of other products such as pensions, personal loans and so forth.

A second pillar of Government policy that encouraged the growth in the demand for financial services was its key policy of privatizing state owned industries and organizations. Not only did the privatizations of the 1980s produce a great deal of

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[217] By the early 1980s investors were becoming increasingly sophisticated. The newspapers (the first being The Mail) began publishing personal finance columns and television programmes such as the 'Money Programme', 'Mrs Cohen's Money' and radio shows like 'Money Box' attracted increasing audiences.

[218] In 1978-79 marginal tax rates were 83% at the top rate and the basic rate of income tax was 33%. Although income tax rates were actually moving downwards from the very high rates seen in the earlier part of the 1970s, the still high rates of direct taxation encouraged people to seek tax shelters.

[219] Up until 1984 life insurance premiums attracted tax relief with buyers of life assurance saving 15% of their cost.

[220] The tax efficiency of mortgage loans for the purchase of residential property was somewhat lessened by Nigel Lawson's budget of 1988 where he, amongst other things restricted mortgage interest tax relief to £30,000 per property rather than £30,000 per borrower as had previously been the case, removed the right of unmarried couples to claim double tax relief, and removed tax relief on home improvement loans. As of April 1994, MIRAS has been reduced to 20%., and as of April 2000 MIRAS will be abolished altogether.

[221] Financial Statistics, Office for National Statistics, various issues.

commission generating business for various financial institutions[222], but it also provoked a great deal of interest in equity based investments.

Finally, the Government had an ideological policy commitment towards transferring state welfare burdens onto the private individual. This combined with shifting patterns of employment from full-time to part-time, from public sector to private sector and from secure to insecure, all of which encouraged an increased demand for long-term savings products.

Having considered both the regulation of investment business before the FSA, and having established a context for the dramatic events that were to follow by setting out the wider economic and political changes that were underway, I shall now consider the factors that led to the commissioning of Professor Gower.

4. The Commissioning of Professor Gower

As was intimated above, the Conservative Government of the early 1980s led by Margaret Thatcher had a number of ideological policy commitments. Thatcherite ideology, was entrenched in the free-market liberalism of Adam Smith (1776), F.A. Hayek (1944, 1948, 1973) and Milton Friedman (1962, 1980, 1983). There was a belief that markets functioned best where there was minimal Government interference. Government's proper role was therefore to maintain a stable currency, law and order, manage national defence and provide the framework "...within which individual families and businesses were free to pursue their own dreams and ambitions."[223] The Government's "...faith in freedom and free markets [and in] limited Government..."[224] led to the radical program of market deregulation and the privatization of nationalized industries of the 1980s. However, there was also a belief that markets did not function in a vacuum. Markets required a regulatory framework, beyond that provided by common law and general statutes, in order to remedy potential abuses arising from market imperfections[225].

In the medium term the Government also had an ideological (and economic) commitment to transfer state burdens onto the private sector. The Government

[222] And again provided opportunities for cross-selling products to customers.
[223] Thatcher, M. (1993) *The Downing Street Years,* (London: The Bantom Press), p.14.
[224] *Ibid,* p.15

believed that individuals should be responsible, for themselves and for their own financial well-being. This commitment was manifested in the encouragement of the public to become shareholders[226], to become home owners through the sale of council houses[227], to invest in life insurance[228] and by the late 1980s, in the encouragement of people to take out personal pensions and opt out of the state SERPS scheme[229].

Financial Scandals

The early 1980s saw a series of financial scandals. Doxford, a minor commodities broker and three investment advisers, Hedderwick Stirling Grunbar, Farrington Stead and Norton Warburg collapsed in 1981[230]. In the most serious of the collapses, that of Norton Warburg, £12 millions of investors' funds were lost after the firm channelled investors' funds into a range of highly speculative ventures. The losses involved in the Warburg scandal of £12 millions is a relatively minor amount in City terms[231], but its political impact was considerable. Particularly as the collapse aroused a considerable coverage in the media. The intense media coverage was due to three reasons.

1. A number of celebrities lost money in the collapse, including members of the popular music group Pink Floyd and the cricketer Colin Cowdrey. Inevitably, the misfortune of celebrities tends to attract media attention.

2. The collapse of Warburgs was particularly embarrassing to the Government because it damaged the Department of Trade. This Department was responsible for the prudential regulation of insurance companies and for the selling activities of insurance brokers (under the IB(R)A 1977), and also had regulatory responsibilities under the PF(I) Act for the activities of licensed dealers in

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225 All of the major privatizations were accompanied by the establishment of a regulatory body, for example OFTEL, OFWAT, OFGAS, OFLOT.
226 Through the tax system, through advertising and through privatization of the national utilities.
227 Mortgages enjoyed tax relief up to the first £30,000 of the house price.
228 Life insurance premium payments were tax free until 1984.
229 This policy was first advanced in a Department of Social Security paper published in 1984, and then in the Pensions Act 1986 which gave people the freedom to opt out of the state and their employer's schemes and set up their own personal pension plan.
230 There were also a series of scandals involving Lloyds and Stock Exchange Members. The most serious of these was the collapse of Halliday Simpson in 1982. This Stock Exchange Member firm was found to have been systematically ripping off its clients using a range of irregular (sic) practices.
231 Especially when one considers that a conservative estimate of the annual running costs of the FSA regime (Franks et al 1996) amounts to £250 million!

securities. The collapse of Norton Warburg was embarrassing because the Department because it had earlier renewed the firm's license despite the fact that its auditors had qualified their report (Clarke 1986). The failure of the Board to act on the auditors' report combined with a regulatory division within the Board that was widely viewed as being under-manned, ineffective[232] and acting with inadequate legislative powers to control investment business.[233]

3. The collapse of Warburgs also embarrassed the Bank of England. The Bank of England had powers under the Banking Act 1979[234] for the regulation and supervision of the banking sector, but the Bank acted as both overseer of the financial system[235], and as the industry's lobbyist in Whitehall (Clarke 1986; Moran 1991). The Bank had acted as a "...Praetorian Guard to protect it [the City] from the emerging system of pluralist politics."[236] The City managed to retain a system of cartel-based self-regulation whilst other industries were subjected to state regulation. The collapse of Norton Warburgs embarrassed the Bank because it had allowed the firm to hold a meeting in the Bank with those of its employees made redundant by the abolition of Exchange Controls in 1979. The Bank had sought to encourage these ex-employees to entrust their redundancy payments to the management of the firm. It was thus embarrassed by the firms' untimely collapse.

The collapse of Warburgs – when taken with the other collapses - thus cast doubt on the competence and the judgement of both of these key regulatory bodies and, more importantly on the general effectiveness of existing regulatory systems.

The collapse of the investment adviser Farrington Stead in 1981 provided further embarrassment to the Government. This firm had claimed to be investment managers in gilts and offered capital gains to prospective investors. Similarly to Barlow Clowes they focused on gilts, speculating wildly on them in their own

232 It was around this time that the satirical journal, Private Eye christened the DTI the Department for Timidity and Inaction.
233 See Gower 1982; Jebens 1996; Lever 1993.
234 This represented the first legal codification of the Bank's regulatory responsibilities.
235 John Ellis, an ex DTI senior civil servant commented "...previously it had been seen as being run like an 'old boys' club and the Governor of the Bank of England waggled his eye-brows and they stopped doing things..." This system of regulation was reasonably successful in the old market which was homogenous and where the emphasis was more on honesty than on competence.

account. As Lever states, "As with Barlow Clowes the normal rules for gilts dealing were thrown out of the window and clients' stock was 'borrowed' to satisfy Hedderwicks' own capital requirements and to finance gambling in gilts."[237]

The occurrence of several scandals in the retail financial services sector inevitably drew attention to their regulation. Some commentators and politicians argued that prevailing regulatory mechanisms were inadequate for the protection of the investor.[238] As Michael Howard - then Parliamentary under-secretary of state at the Department of Trade and Industry – later stated "...I think that it was felt that something more needed to be done, that it wasn't right that people should be able to hold themselves out as fit and proper people to take charge of peoples' financial affairs and their money without being properly authorized to do so."[239]

Despite the small amounts lost, these scandals had serious consequences. At a time of growing crisis in finance, the Government, which was increasingly being attacked for being soft on its friends in the City[240], faced immediate pressure from the media, from consumerists, and from the opposition parties for *something to be done* about white-collar financial services crime. In short, the "Government decided that reforms could not be put off any longer."[241] The Government responded in time-honoured fashion by commissioning an academic lawyer to conduct an inquiry into the regulation of investment business and to write a report outlining recommendations for reform.

The Commissioning of Gower

The DTI's adviser on company law, the eminent Professor L.C.B. 'Jim' Gower was persuaded, reluctantly to undertake a comprehensive review of the regulation of the investment business. Gower himself was surprised at being chosen to undertake the review as he felt that he would not be acceptable to the City, but as he later stated, "...apparently the Establishment failed to black-ball me - probably, in the light of their subsequent reactions, because they had failed to recognize the wide terms of

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236 Moran, M. (1991), *op. cit.*, p. 62.
237 Lever, L. (1993) *The Barlow Clowes Affair,* (London: Coronet Books), p.34.
238 See Llewellyn 1986; Goodhart 1987, 1989.
239 Michael Howard, *op. cit.*
240 John Smith commented "One reason why the Government do not share that view [that the case for an independent statutory commission was overwhelming] is that they do not want such an effective institution as those who are to be regulated are, by and large, the Government's supporters" (John Smith, Financial Services Bill, second reading debates, January 14, 1986, Hansard, p.958).

reference covered their operations and not merely those of the small fry."[242] Gower had a clear notion of what was required:

> For what I believed was needed was something similar to the system adopted in the United States some 50 years earlier and later copied, with modifications, by many Commonwealth and foreign countries. I wanted statutory control of investment business, widely defined, under which all those conducting that business would be authorized by, and regulated through, membership of a few self-regulatory organizations recognized by, and, under the surveillance of, a governmental or quasi-governmental body which, ideally should be a self standing commission.[243]

However, the City argued that "self regulation (in their sense) was a panacea and that it works only when it is left free from any form of governmental surveillance."[244] In a climate manifestly opposed to the prospect of regulation, Gower set about producing a discussion document.

Gower's Discussion Document

Gower, working with a minimal staff at the DTI, produced a discussion document in 1982. Gower was critical of both the inadequacy and the untidiness of the prevailing system of regulation. He identified a number of problems with the system of regulation:

1. There was no single system for the investment industry and the securities industry, no single prosecuting authority, and no clear remedy for the compensating investors in the event of loss.

2. There was insufficient regulation of the marketing operations of investment products by banks, building societies, life insurance companies and unit trust companies. Whilst the actual operations of these companies were quite tightly regulated the marketing operations of the companies were not.

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[241] Gower, L., (1988) *op. cit.* p.8.
[242] Ibid.
[243] Ibid.
[244]Gower, L. (1988) *op cit*, p.9.

3. There was a dramatically growing number of almost entirely unregulated firms who were advising on the sale of, and management of investment products.

4. Changes in the market for investment products, which included a move to indirect personal investments[245] and the proliferation of investment media[246] rendered the existing regulatory regime out-of-date and inadequate.

Having highlighted what he perceived were the weakest features of the prevailing regulatory regime, Gower considered the relative merits of self-regulation and government regulation. Gower laid stress on the complementary nature of self-regulation and government regulation but argued that the disadvantages of self-regulatory control mechanisms could be most effectively minimized if they were set within statutory framework.

Gower's Proposals for Reform

In considering the possible models for a new regulatory regime Gower presented a number of practical considerations, or constraints which are clearly instructive of the political framework within which Gower was working:

- The Government policy of reducing the size of the civil service and of the number of QUANGOs should be taken into account. This had clear implications for the likelihood of a Government commission or Government department running the regime.

- Gower summarily rejected the prospect of abolishing governing regulation and reverting to laissez-faire and caveat emptor.[247] Political demands were for some grand, symbolic action not for withdrawal of the state from regulation in this sector.

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[245] Especially the growth in the popularity of unit trusts, occupational pension schemes and commodity funds.

[246] The abolition of exchange controls meant that off-shore funds were now available as retail investments and a whole range of complex new derivatives products were becoming available for retail investment.

[247] Although he does this with little reasoned argument or economic debate – a precursor to his general disregard for economic analysis during the entire review.

- There was a recognition that there should be a scaling of protection, namely that 'Aunt Agatha' should be provided with greater protection than the professional investor.

- Gower recognized that there needed to be a distinction between different types of securities: which should be banned, which should be subject to regulatory controls, and which should be available without regulatory controls.

- He asserted the need for a system of tight supervision, stating that however good they are, regulations will sometimes be breached and that these breaches need to be detected as soon as possible, ideally before loss is incurred.

- Recognizing that sometimes rule breaches will not be detected in time to avoid loss, Gower also stressed the need for a safety net which is best provided through a compensation fund. However, he recognized the moral hazard dangers of a compensation fund, namely that it involves "the honest and competent paying for the sins of the dishonest and incompetent,"[248] but argued that potential systemic risk of clients losing money is too great to be over-ridden by this danger.

- He recognized that ultimately either the investor or the tax-payer will pay for the regulatory regime and highlights the strong precedent of Government regulation in this area being funded by collecting fees from those regulated. He therefore warned the industry that Government regulation will be no cheap option for them or their clients,

- Finally, Gower recognized the realities of the highly competitive global market in financial services and stated that "it would be lamentable if our regulations were so strict in comparison with those of other countries that London ceases to be the world's centre for financial services as it still is."[249] On the other hand, he also

[248] Gower, L. (1988) *op. cit.*, p.85.
[249] *Ibid*, p.86.

argued that if regulation is too lax, confidence will be lost in the British market and business will also move to more attractive markets.

Within these constraints, Gower identified a number of possible approaches:

- ***Do Nothing.*** He rejected this approach stating that "Everybody now seems to be agreed that something needs to be done."[250] Political demand for symbolic action was clearly overwhelming

- ***Revise the PF(I) Act.*** This minimalist approach whereby the overall structure of regulation would be left unchanged but the worst elements of the regime would be modernized could, according to Gower, achieve something. However, he rejected this approach on several grounds, principally on the basis that it would not have an overall strategic purpose.

- ***Co-ordinate the existing Act with other controls.*** This would involve converting the PF(I) Act into a Securities Act by considerably increasing the scope of the existing Act and reforming its worst features. Gower rejected this approach because it "would do nothing to establish a more coherent and better balanced relationship between Governmental regulation and self-regulation" (Gower, 1982, p.89).

- ***Set up a Securities Commission.*** A new statutory agency could be established, with "executive, judicial and delegated legislative powers over the whole of the operations which can be properly regarded as part of the securities industry."[251] This could have been along the lines of the American SEC model or, more likely along the lines of those developed in Hong-Kong, Canada and Australia. Having cited the numerous advantages of such an approach, Gower rejects it on the grounds that "I do not believe that it would, at the present juncture, be practical politics."[252] In particular, the opposition of the Government to QUANGOs is cited as a major reason for the rejection of the approach. On top of the issue of political

[250] *Ibid.* p.87.
[251] *Ibid,* p.89.
[252] *Ibid.* p.91.

acceptability, Gower highlighted the opposition in the City to such an approach. He commented, "For I have been left in no doubt of the City's rooted objection to a Commission and it cannot be ignored even if it may be thought somewhat irrational in the light of the fact that a Commission need not (and should not) rule out at least as much self-regulation as we have at present...I cannot picture a Government of any complexion forcing a Commission upon it in the near future."[253] This comment is clearly indicative of both the power of the City to effectively veto any regulatory plans that it didn't agree with and of the opinion of Gower as to the unwillingness of any Government to take the City on.

- ***An adjusted balance between self-regulation and Governmental regulation.*** This half-way-house solution, was proposed by Gower as the ideal solution and it essentially involved the devolving of day-to-day running of a new regulatory regime to self-regulatory agencies - covering the whole industry - and a Government department or agency running overall regulatory policy and strategy.

The Reception of Gower's Discussion Document

The Discussion document that was produced by Gower in 1982 "...received a hostile reception in the City..."[254] His proposals were received with warm approval from consumerists and the media but, in Gower's words "...the main City bodies were livid [with his proposals]."[255] Gower was widely perceived as being a archetypal academic who was out-of-touch and lacking a real grasp of matters. Sir Nicholas Goodison, then Chairman of the London Stock Exchange, summed up this attitude in his comments on Gower's Discussion Document in 1982, which described the report as expositing "...theoretical coherence and tidiness"[256]. In the view of the City elite, the suggestion that the merchant banks and stock-exchange member firms should be exposed to external state regulation was anathema. They argued that "...self regulation...was a panacea and that it works only when it is left free from any form of governmental surveillance."[257]

[253] *Ibid.* p.91.
[254] Moran, M. (1991), *op. cit.* p.71.
[255] Gower, L. (1988), *op. cit.*, p.9.
[256] Stock Exchange Annual Report and Accounts, 1982, pp. 3-4.
[257] Gower, L. (1988), *op. cit.* p.9.

Although the discussion document received a generally hostile reception in the City, the report did "...prompt serious thought on reform and investor protection by the relevant bodies..." and acted "...to gear up public debate, and to mobilize City opinion to consider more than token changes..."[258] Gower however felt that nothing would come of his review, and like so many other government commissioned reports it would be condemned to the archives of Whitehall. This may well have happened with Gower's recommendations[259] but for a range of events which were to both draw more attention to financial services regulation in 1983-1984 and to arouse industry demands for Government intervention. As Gower was later to say "Events [in 1983/ 84] achieved what arguments and persuasion would not have done."[260].

5. Scandals, Market Reform and Deregulation

Following Gower's Discussion document, moderate changes were made to the regulatory regime in 1983 and 1984. These included a re-drafting of the Licensed Dealers (Conduct of Business) Rules and the implementation of several European Community directives[261]. However, Gower felt that these changes did not have the desired effect and that more fundamental change was required.[262] The support for whole-scale reform was strengthened by the events on 1983-1984. Two pressures converged to arouse industry and political desire for the reform of the regulation of financial services.[263] As Gower stated in the second part of his report

> Those bodies which, in response to the original Discussion Document of January 1982, had attacked the basic concept of comprehensive legislation regulating investment business and based on self-regulatory agencies recognized by, and subject to the surveillance of, a Government regulator now accepted it and no longer argued that self-regulation worked only if it was totally free from any outside control[264]

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[258] Clarke, M. (1986) Regulating the City: Competition, Scandal and Reform, (Open University Press) p.118.
[259] And the token changes made in 1983-1984 been an end to the reforming programme.
[260] Gower, L. (1988), *op. cit.* p.10.
[261] The European Community measures included the European Community directive for admission 79/279/EEC, the Listing Particular Directive no. 80/390/EEC and the Interim Reports directive no. 82/121/EEC.
[262] See Gower 1984; Jebens 1997.
[263] Which was being resisted by powerful City interests including the Accepting Houses Committee, the Stock Exchange and the ABI.

The first of these pressures came from the reform of the Stock Exchange precipitated by the Goodison-Parkinson Agreement, the second from a trio of deregulatory changes in 1983-1984, and finally, from the further series of financial scandals. These three pressures are now considered.

Reform of the Stock-Exchange

The agreement reached between the Government and Nicholas Goodison in 1983[265] signalled not only the imminent reform of the stock exchange, but also that of the wider financial services industry[266]. Extensive meetings were held between the Secretary of State for Trade and Industry, Mr Cecil Parkinson, the Chairman of the Stock Exchange, Sir Nicholas Goodison and the Office of Fair Trading to try and resolve the affair before the first Restrictive Practices Court hearings in 1984. A deal was struck in July 1983, whereby the stock exchange agreed to abolish fixed minimum commissions and the system of single capacity, and to remove the barriers to outside ownership of stock-exchange member firms by 1986 in return for the Government withdrawing the Office of Fair Trading's legal case. There followed almost immediate changes in the structure of the exchange. Between 1983 and 1986 ownership patterns changed markedly, one hundred and five stock exchange member firms were subject of outside participation in ownership, over thirty of these involving foreign concerns (Moran 1991). The City was rapidly becoming a truly global, cosmopolitan market.

The deal also represented a major blow to the OFT[267]. But, more importantly it transformed opinions about the existing regulatory framework for financial

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[264] Gower, L. (1985) Review of Investor Protection: Report Part II, (London: HMSO), p.4.
[265] The Goodison-Parkinson Agreement.
[266] Although as John Smith was to argue later when debating the FSA, whilst "the Secretary of State presented the arrangements that were made between... [Mr Parkinson]... and the stock exchange as some carefully planned imaginative change for the future. It is nothing of the kind. It was a hastily cobbled deal to exclude the stock exchange from the restrictive practices court. It will bring about a series of changes that will alter the face of the City and which the authors of the agreement had not the slightest conception would occur when they entered into it" (John Smith, Second Reading Debate on the Financial Services Bill, January 14, 1986, Hansard, p.955). In addition to Opposition concern at the deal, members of the Conservative party also considered the Goodison-Parkinson agreement to be a cosy deal between the Government and its friends in the City (See The Times editorial, July 29th, 1983, "Competition not Corporatism").
[267] In fact the OFT refused to voluntarily withdraw its case thus forcing the Government to legislate in order to exclude the stock exchange from the clutches of the OFT and the Restrictive Practices Court. This was followed later when having reported that the SIB rule-book was anti-competitive, the OFT was over-ridden by the Government.

services.[268] Almost immediately after the stock-exchange rules on ownership were relaxed, financial institutions rushed to buy jobbing and broking firms. Many new foreign based firms entered the City and a new phenomenon of the financial conglomerate emerged which brought with it contingent regulatory dilemmas, especially regarding conflicts of interest. The dramatic changes that Big-Bang brought to the City meant that whilst the first discussion document had received a severely hostile reception, by the final report there was some acceptance that a new regulatory framework was now not only inevitable, but also desirable.

A Trio of Deregulatory Initiatives

At the same time as the Goodison-Parkinson agreement was reached to signal the de-regulation of the London Stock Exchange, three other critical de-regulatory initiatives were also underway. In 1983, the building societies' cartel broke down under the competitive pressures from the banks who had aggressively entered the mortgage market in the last few years. In the face of heavy lobbying, the Government published a Green Paper in July 1984 outlining a new regulatory regime for the Building Societies. The proposed regime was fundamentally de-regulatory in character, the most important elements being to allow Building Societies far greater freedom to expand their banking activities (including the freedom to access wholesale funding) and to sell a wider range of financial services.[269]

A second initiative in 1983 was the publishing of a consultation document outlining the Government's plans on personal pensions. The idea of personal pensions had come from a policy document published by the right wing think-tank, the Centre for Policy Studies, in April 1983. The paper, titled "Personal and Portable Pensions for All" was written by Nigel Vinson (then deputy chairman of Barclays Bank) and it argued that occupational pensions were wrong in several respects. According to Vinson occupational pensions penalized those who changed their jobs often, they were unfair, (i.e. because early leavers effectively subsidized 'plodders' who stayed in one job all their lives) and they were undemocratic because they denied people the right to control the level of their contributions and to carry a personal pot with them

[268] Gower's blueprint for reform had little support up to then.

[269] The Building Societies Act also made provision for the mutual building societies to covert to proprietary status and become de facto banks. The Act also established the Building Societies Commission to implement the new rules.

from job to job. Vinson wrote, "the law actually results in a continuing shift of capital from the personal to the corporate sector. And for most people today, ownership is ownership at second hand, and as such, is not ownership in the motivational sense."[270] He recommended instead that people should have their own private portable pensions, which would be their responsibility and which they would keep wherever they worked. This, "...would give a new opportunity for . . . people to have a real sense of involvement in the industrial success of this country."

Not surprisingly, the proposals found favour with a Government which had to tackle the demographic problems of an ageing population[271]. The introduction of personal pensions would also encourage greater mobility and flexibility in the labour force as part of the Government's supply side reforms. Moreover, the concept of the personal pension could be sold on the basis that it was a way to break away from the chains of the state[272] and would also be popular with both employers (who would be able to reduce their occupational pension commitments if their employees opted out) and with the self-employed.

After the General Election victory of 1983, the Government acted when Norman Fowler, then Secretary of State for Social Services, set up a committee[273] to examine the problem. The committee included influential figures from the financial services industry including Mark Weinberg, a founder of three top insurance companies. The committee also included Professor Alan Peacock, Vice-Chancellor of the privately funded Buckingham University. The ultimate outcome of the committee's deliberations was that measures were included within the Social Security Act 1986 to permit individuals to establish their own personal pension schemes.

The final de-regulatory occurrence was the collapse of the insurance industry's commission fixing agreement on January 1st 1983. This event had significant

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[270] See the *Independent on Sunday*, May 22 1994, "The great pensions scandal: When you get to their age, you may not have enough to live on." By Nick Cicutti.

[271] Treasury forecasts showed that the number of retired people, at about 10 million in 1983, would rise rising steadily from the year 2000 until it reached 15 million. At the same time, so the Treasury forecast suggested, the number of people of working age was expected to fall from a peak of 37 million to about 33 million. This was worrying because in the state system people in work pay the pensions of those who have retired (the state pension is not a *funded* scheme) and, in return, expect the same to happen when they stop working. If, by 2030, a much smaller number of working people were carrying the burden of a much larger number of retired people, it was difficult to see how reasonable pensions could be maintained without very large rises in tax levels.

[272] Indeed, the advertisements used by the Government to advertise personal pensions in 1988 used the imagery of breaking away from the chains of the state quite explicitly.

[273] The Pensions Reform Committee.

implications. According to the industry, commissions fixing was essential in order to avoid a damaging commissions war which would result in both damaging competition for distribution and in price rises. The collapse of the agreement aroused concern amongst the old established insurance companies that new insurance companies were entering the market and were capturing market share by paying higher commissions to advisers[274]. These new firms, many of whom entered the UK market from overseas[275], were busting existing cartels one after the other. This was the main cause of the collapse of the industry's commission fixing agreement (run by the two main professional organizations, the Life Offices Association (LOA) and the Associated Scottish Life Offices Association (ASLO)). By staying outside the industry commission agreement the firms had been able to capture market share by paying higher commissions to advisers.

Following the collapse of the LOA/ ASLO commission fixing agreement, in late 1983 eighty large life offices attempted to establish a Registry of Life Assurance Commissions (ROLAC) to operate a scheme for maximum commissions in the life assurance industry. Events soon overtook the ROLAC scheme, but its purpose was clear; to prevent competition on commissions that was allowing innovative firms to capture business (i.e. to try to maintain the cartel). The life offices did not like the prospect of a substantial increase in their costs of distribution and so lobbied for Government assistance.

A Further Series of Financial Scandals

The period 1983-1984 also witnessed further financial scandals which caused new damage to the existing system of regulation. The worst of these was the Johnson Matthey affair, which came to a head in September 1984 when the Bank of England bailed it out and bought it for the nominal sum of £1. The debacle had two important effects:

- It damaged the regulatory authorities, and especially the Bank of England. The Bank of England had failed to recognize that the firm had grossly violated the

[274] Jebens, Sir Kit., (1996), *Lautro – A Pioneer Regulator 1986 – 1994,* (Published by Kit Jebens).
[275] After the abolition of exchange controls in 1979 a plethora of foreign companies entered the British market which had previously been insulated from competition, cartelized and was now a growing market and ripe for foreign competition.

Bank's prudential rules by lending 115% of its total capital to two foreign businessmen when the Bank of England recommendation was for no more than 10% to be lent to any one borrower.

- The episode cast further disrepute on the system of informal self-regulation and damaged the Bank of England, weakening its position in lobbying for the City's interests. In the immediate aftermath of the debacle, the Deputy Governor of the Bank, Kit McMahon left his post, and George Blunden, the man who saw the bank through the Secondary Banking Crisis of 1974-75, came out of retirement to take McMahon's post. The scandal aroused widespread indignation and started "...an intense campaign in the media and in Parliament against fraud in the markets."[276] The longer term consequence of the Johnson Matthey debacle was the replacement of the Banking Act 1979 with the more formal controls of the Banking Act of 1987.

There were also scandals in the personal finance sector of the industry, including one involving Exchange Securities and Commodities, based in Warwick, which collapsed in 1984. The collapse was precipitated when the owner, Keith Hunt vanished along with £10 - £20m of investor's funds. In what was seemingly an increasingly common phenomena, ordinary investors found that they were easy prey to fly-by-night salesmen and profit hungry entrepreneurs. There was also growing concern as to the conduct of so-called foot-in-the-door salesmen selling insurance and the like. The activities of the large sales-forces of some of the insurance companies were arousing concern in the media, specifically over the standards applied in recruitment and training, the practices connected to the sale of endowment mortgages, and related to the use of commissions and high pressure selling techniques.

An Overview of the Process which led to the Gower Report

The scandals outlined above only added to the evolving consensus that *something must be done.* The Conservative MP Mr Anthony Nelson captured the political mood of the time, stating that

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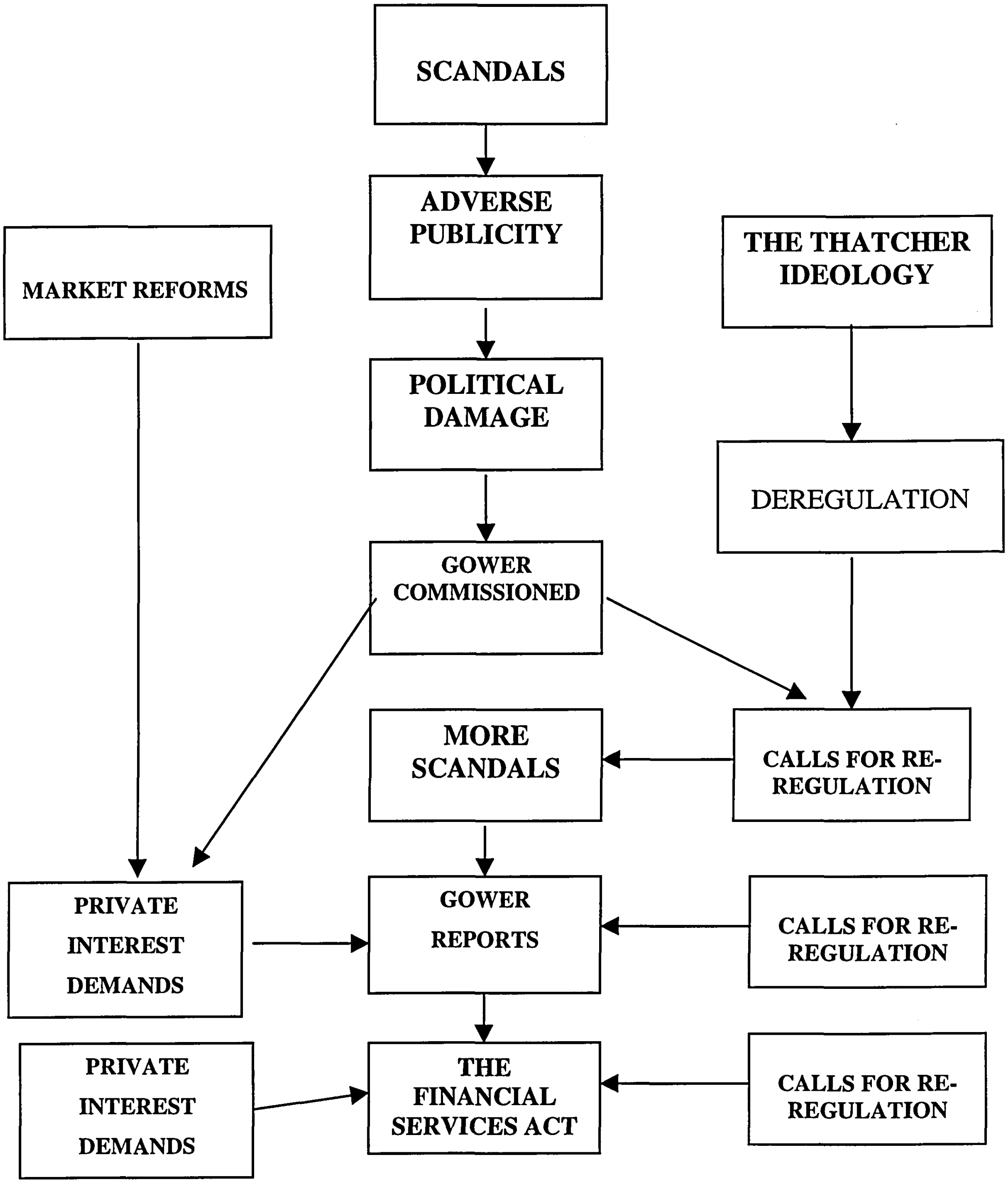
[276] Moran, M. (1991), *op. cit.*, p.81.

> these changes [as outlined above] have left the investor more vulnerable to malpractice and fraud, created apprehension about future standards of conduct and conflicts of interest, and undermined the old adage, 'My word is my bond' to the extent, sadly, that the new motto ought to be 'My word is my flexible and revocable instrument', with the result that statute law is a more important basis of regulation than the convention of voluntary good behaviour or than common law which has thrown up some conflicting and inadequate judgements in recent years.[277]

Everything combined to produce the momentum necessary to encourage the Government to act, and act decisively. The range of pressures that acted to bring about the revolution in regulation are illustrated in the chart below. Initially, it was scandal which played the main role. Scandals created political damage for the Government and encouraged it to order an investigation, conducted by Professor Gower. However, in 1983-1984, two further pressures combined with yet more scandals to create the momentum necessary to encourage the Government to act. Dramatic changes to financial services markets then combined with Thatcherite ideology (for deregulation) to unleash powerful reforming interests from within the industry.

[277] Mr Anthony Nelson, Financial Services Bill Second Reading debates, Hansard, January 14, 1986, p.990.

Figure 4. Exogenous Influence Dynamics.



The events of 1983 were critical to the origins of the FSA. As Gower concludes

> Revelations about the scandals at Lloyd's, misdeeds by some stock exchange members and criminal behaviour and the collapse of many commodity firms tarnished the City's reputation both nationally and internationally. It became increasingly difficult for anyone to argue that self-regulation was working perfectly or that it worked best when, as with Lloyd's it was left free from any outside surveillance.[278]

To summarize, three pivotal developments occurred in 1983: (i) the old system of cartel based self-regulation was damaged by successive scandals and crises. Political damage from these scandals led to pressure on the Government to consider reform. (ii) The powerful de-regulatory pressures underway by 1983, including that signalled by the Goodison - Parkinson agreement, but also in the banking and building society sectors and in the life assurance industry, meant that there were heightened political interests for re-regulation and also industry demands for new sources of self-regulatory authority. And (iii) Gower was on hand to provide one obvious source of justification for reform.

6. The Gower Report: Recommendations

Gower completed his main report in October 1983, and his views were to have a decisive effect on the subsequent legislation. Gower was a lawyer's lawyer and saw the problem of investor protection in narrowly legal terms. He had no interest in the economics of regulation, and made no effort to come to grips with the economic issues involved.[279] He therefore ignored the potential role of competition in protecting investors and paid little attention to the compliance or other costs of his recommendations. He also had little to say about the objectives of regulation,[280] and showed no apparent awareness whatever of public choice issues.

The Gower Report was finally published in January 1984. By this time there was a general acceptance that statutory regulation was inevitable, probably administered by a self-standing commission[281]. A comprehensive regulatory framework with statutory backing to which all firms would be subject was attractive

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[278] Gower, L. (1988), *op. cit.*, p.9.

[279] To his credit, Gower was also engagingly frank, and famously commented that he had rejected the use of cost-benefit analysis partly because he was not competent to conduct one!

[280] Indeed, his only explicit objective was to invoke the legal notion of the reasonable man and suggest that regulation "should be no greater than is necessary to prevent reasonable people being made fools of, but should not protect fools from their folly." The failure to define clear objectives for the FSA and the implications of this are considered in detail in the following chapter.

in that it would allow the stock exchange to remain dominant.[282] A system of self-regulation with statutory teeth also appealed as a solution to the problems in life assurance – especially the danger of a commissions war. Gower made his own views clear, "I made it pretty clear that I favoured a commission but conceded that the role could be left to the department if, when legislation was introduced, it seemed clear that a few firms only would elect to be directly authorized and regulated by it."[283]

Whatever system was adopted, Gower recognized that no system of regulation would totally eradicate incompetence and fraud. "The City has always had its share of crooks, charlatans and incompetents and although the club was rather good at enabling its members to identify them, it was very bad at putting them out of business. Many of them continued to flourish and to rip off those who were not members of the club: one actually became Lord Mayor of London."[284]

Focusing on the retail side of the industry, Gower identified two central problems with investment business and proposed a number of objectives to remedy them:

(1) Before the enactment of the FSA, those firms offering advice on life assurance and other investment products operated in a lightly regulated environment and were, in general not regulated by any specific regulatory body. Financial advisers were able to recommend any product, often from a narrow range and received a substantial commission for selling them. A major problem with the system was the problem of commissions bias whereby the incentive of earning commissions and fees for the salesmen rather than the requirements of the investor, determined the product offered.

(2) That from time to time small investment firms go bankrupt and investors lose money. Occasionally the owner of the investment business disappears with the investors' money as in the case of Norton Warburg.

Gower proposed a new regulatory regime to address these problems.

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[281] Jebens (1996); Moran (1991); Clarke (1986); Gower (1984, 1988).
[282] As there would be no appeal to side-stepping stock exchange laws if they applied to all operators.
[283] Gower, L. (1988), *op. cit.*, p.10.
[284] Gower, L. (1988), *op. cit.*, p.16.

Gower's Blue-Print for Reform

Gower's key recommendation was for the establishment of a regulatory system for the conduct of investment business founded on the principle of self-regulation within a statutory framework. Gower argued forcefully for the advantages of practitioner based regulation, but contended that self-regulation worked best under a statutory framework. At the head of the regime would be the SIB[285], a private body with a statutory function whose role it would be to operationalize the Act through the creation of a rule-book of best practice. The SIB would then authorize a series of Self Regulatory Organisations (SROs), Recognized Professional Bodies (RPBs) and Recognized Investment Exchanges (RIEs) who would have the task of the day-to-day regulation of the industry. It is this third tier of regulation (below the Secretary of State and the designated agency) which provides the crucial *self-regulatory* element of the FSA regulatory regime. This third tier, namely the SROs, RPBs and RIEs would have to satisfy the SIB that they were capable of exercising their regulatory function in an *efficient and effective* manner, that they were *viable* and that their rule-book offered at least *equivalent protection* to the investor as that of the SIB's rules. The panoply of self-regulatory bodies would also deal with investor complaints and would provide clients with known and adequate channels of complaint.[286]

Gower's Proposed Self-Regulatory Structure

Initially five SROs were authorized with varying roles and responsibilities and organized along clear functional grounds.

- **The Association of Futures Brokers and Dealers.**

The AFBD was formed in 1979 after the Banking Act of that year but in 1984 it was incorporated as a company limited by guarantee by its first members, namely the London Metal Exchange, the London International Financial Futures Exchange, the London Commodity Exchange Company and the Grain and Feed Trade Association.

[285] The Act actually gave powers to the Secretary of State but also made provision for him to devolve regulatory powers to a 'designated agency'.

- **The Investment Management Regulatory Organization.**

IMRO was formed in 1986 and includes the large scale investment fund managers.

- **The Life Assurance and Unit Trust Regulatory Organization.**

One of the critical SROs in the regime, Lautro regulated the marketing and sale of life assurance by life offices, friendly societies and unit trust managers. However, the coverage of Lautro only extended to the sale of these products through employees or appointed representatives. The sale of products through IFAs was covered by FIMBRA.

- **The Financial Intermediaries, Managers and Brokers Regulatory Association.**

Although originally incorporated in 1979 as The Association of Licensed Dealers in Securities, it existed as FIMBRA from July 1986 to 1995 when the PIA took over its regulatory responsibilities. FIMBRA regulated the marketing and selling of life assurance by independent financial advisers and intermediaries. With several thousand firms applying for membership, many of whom being one-man firms, often conducting investment business as a supplementary activity to their main business, the task of FIMBRA under the FSA was clearly a substantial one. Lomax identifies the three areas of business that FIMBRA members engage in:

- dealing in securities as principal;
- dealing in securities as an agent; and
- investment management.

- **The Securities Association.**

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[286] This will be considered later, but a flaw in the FSA regime has been the absence of clear channels of complaint. A plethora of compensation schemes and ombudsmen have evolved in the financial services area.

This SRO regulates the essentially wholesale, professional equity, derivatives and commodity markets.

The Principle of 'Positive Authorization'

Gower also recommended a system of positive authorization. This required that before firms and individuals were allowed to carry out investment business[287], they would have to receive prior authorization by the regulatory authority. The rationale for this was that prevention is better than cure, and that it is preferable to ensure that people do not undertake investment business unless they are *fit and proper* to do so and, moreover that they satisfy the regulatory body that they are. To meet the fit and proper test, a firm "must satisfy various criteria relating to its *capital adequacy, its previous business record*, the arrangements to be put in place to ensure *compliance with supervisory requirements*, and the *good character of its owners*, directors and employees."[288] The fit and proper criteria can therefore be divided into four:

- Financial integrity and reliability: The firm should be solvent and it should have sufficient resources to meet its commitments on a continuing basis and to withstand likely financial risks.

- Competence: All firms must demonstrate sound internal compliance arrangements and applicants seeking individual authorization must have suitable experience and qualifications.

- Reputation and character: criminal convictions, past refusals for authorization, contravention of FSA rules, the provision of false or misleading information to the regulator and the failure to observe good market practice may all be considered.

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[287] The precise definition of 'investment business' was drawn very widely at this point and included those who were engaged in investment business as a minor part of their business activities. When the Financial Services Bill went through Parliament in 1985-1986 many exceptions were granted, with particular emphasis placed on offering immunities to those who did not engage in investment business as a major part of their business.

[288] Goacher, D. (1993) *The Monetary and financial system*, (Chartered Institute of Bankers), p.194.

- Efficiency, honesty and fairness: The regulator must be sure that the firm, if authorized will conduct business fairly, operate efficiently and deal candidly with it.

Furthermore, the firm was to be required to submit a business plan which had to specify the nature of the business, the type of customer, the means for dealing with complaints, and the arrangements for complying with rules.

Anyone conducting investment business without such authorization was to be subject to the criminal law and subject to fines and imprisonment up to seven years.

The concept of positive authorization aroused allegations from some quarters[289] that regulation was merely going to replace the restrictive entry barriers that had been imposed by the self-regulatory cartels of old with new state-backed ones. Len Ross argued that "Gower is effectively proposing the creation of state-validated cartels with the powers to restrict entry and to drive out of business those who do not conform to their anti-competitive practices."[290]

Rule-Books of Best Practice

A third key recommendation of Gower was for rule books of best practice to be imposed on authorized firms. In order to deliver better investor protection, Gower advocated a system of limited disclosure of commissions (for brokers) combined with the establishment of an industry-wide commission agreement. In addition Gower favoured the outright banning of practices such as churning, volume over-riding, and cold-calling. The suggestion that the insurance industry should be allowed to re-instate its desired goal of fixing commissions aroused vigorous criticism. As Ross commented,

> Gower claims that price-fixing is necessary for investor protection. This, he says is because brokers cannot be impartial in advising customers on life policies and other investments if they get a bigger rake-off from one than another... But Gower shows a complete misunderstanding of the beneficial effects of free competition...Under competition, the ultimate constraint on the brokers is what the customer wants and is

[289] Including from Seldon et alia (1989).
[290] Ross, L. (1984), *op. cit.*, p.51.

prepared to pay; no amount of pushing particular investments will force consumers to buy an inferior product.[291]

Gower also advocated strict monitoring of firms, principally by the SROs to ensure compliance and to ensure that firms are put out of business as rapidly as possible if they transgress and, if their offence is sufficiently grave, that they are prosecuted.

Finally, Gower advocated the establishment of a system that would provide clear channels for consumer complaints and, as a safety net, compensation in the event of loss through fraud, negligence, collapse and so forth.

7. The Re-election of the Conservatives: A Radical Agenda

The Government interpreted the election result of 1983[292] as a powerful mandate to press ahead with the Thatcherite programme of privatization and deregulation.[293] However, the immediate concern for the Government in financial services was with regulation not deregulation. As was argued in Parliament,

> If the Government cherishes...the vision of an equity-earning democracy, with greater encouragement for ordinary families to invest their savings in shares, it faces an inescapable duty to ensure that financial markets are honestly managed and that transgressors are swiftly and effectively discovered, convicted and punished".[294]

The Government, in order to placate its critics and to appear to be 'doing something' thus decided to act on the recommendations of Gower. The Government acted by establishing a number of industry dominated committees to decide on how a new regulatory regime should be constructed.

One committee was established by the Governor of the Bank of England in May 1984 under Sir Martin Jacomb and comprised of the City elite. Another was set up under the chairmanship of Mr Marshall Field, ex-head of the Life Offices Association[295] representing the 18 trade associations[296] Both groups reported secretly

[291] Ibid.
[292] On June 9th 1983 the Conservative party, led by Margaret Thatcher was re-elected with a greatly increased majority of 144 seats.
[293] Thatcher, M. (1993), *op. cit.*, p.306.
[294] Mr John Whitfield, Financial Services Bill, Second Reading, January 14, 1986, Hansard, p.996.
[295] The Life Offices Association had managed the industry commission fixing arrangement which broke down in January 1983.

in August 1984 but neither of the reports were published or even officially acknowledged. Gower mischievously comments that "GAG, the acronym by which the Governor's Advisory Group was known, was singularly apt".[297]

In addition to these committees, two regulatory organizing groups were also established. One of these, MIBOC[298] was endowed with the task of formulating proposals for the regulation of the retailing of financial services. The man chosen to head the group was Sir Mark Weinberg, an insurance industry entrepreneur who had clear sympathies with the life office side of the industry[299]. His task was to broker a regime that would be acceptable to both the Government and to the industry. The other body was the SIB[300], which was chaired by Sir Kenneth Berrill.[301] The deliberations of the four bodies were followed by extensive debate between the Bank of England and the DTI, a report known as the Treaty of London was produced, and although this document was never officially acknowledged, it led to a White Paper published on October 17, 1985 (Gower 1988; Clarke 1986; Moran 1991).

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[296] The group was chaired my Mr Marshall Field (head of the Life Offices Association) and included other members of the LOA, members of the Association of Scottish Life Offices (ASLO), the Industrial Life Offices Association (ILOA), the Unit Trust Association (UTA), the Building Societies Association (BSA), representatives of the Friendly Societies and finally representatives of insurance brokers. The group's primary purpose was to consider whether a new regulatory structure should be founded on functional or institutional divides. Much to Gower's chagrin, the group came out strongly in favour of an institutionally based structure, although a functionally based system would have made more sense given the trend towards diversification within the industry. However, the strong tribal divisions within the industry made the decision of the group almost inevitable. Other than this, the group merely expressed a willingness to form an SRO, nonetheless as Gower (1988) comments, as this was almost the first time that they had agreed on anything, it was actually a considerable achievement.

[297] Gower, L. (1988), *op. cit.*, p.11.

[298] The Marketing Investment Board Organizing Committee.

[299] Weinberg's appointment provoked amazement in certain sections of the industry, "Mr Norman Tebbit, Secretary of State for Trade and Industry, has stunned a large section of the financial community by appointing Mr Mark Weinberg as chairman of the organising committee of the proposed Marketing of Investments Board. Mr Weinberg is famous for building up one of the more aggressive direct selling life offices, Hambro Life. For some three days a week, he will continue to run this business." *The Financial Times*, April 1st, 1985. "Lombard: Self-regulation Or Self Interest / Marketing of Investments Board", by Barry Riley. "The very appointment of Mr Weinberg, and the members of his board, sparked off fierce criticism from independent intermediaries and life offices such as Scottish Equitable and UK Provident which market exclusively through them. They argued that the balance was struck too much in favour of tied agents." *Financial Times*, April 24 1985 "Survey of Insurance And Insurance Broking (8): A Need For Quick Agreement / UK regulation" By Barry Riley.

[300] The Securities and Investment Board.

[301] Berrill was not the first choice for the job, Martin Jacomb, one of Lawson's old colleagues from the FT, had been first choice (Lawson, 1991, p.401). However, he had been too busy to undertake the role. As Lawson reflected "One of the practical problems with practitioner-based regulation is that

8. The White Paper: A Myriad of Interests

In October 1985[302] the Government published a White Paper[303], 'Financial Services in the UK: A New Framework for Investor Protection.' In broad terms the White Paper reflected Gower's final recommendations for a regulatory system based on self-regulation within a statutory framework and overseen by a statutory body, the SIB. Gower's views on the proper level of regulation were also broadly accepted:

> ...the regulation of the financial services industry should be no more than the minimum necessary to protect the investor...Investment - as distinct from saving with a bank or building society - necessarily entails taking deliberately considered risks. The aim is to see risk-taking fairly rewarded, to foster the spirit of enterprise but to reduce the scope for losses resulting from fraud, or from the concealment of risk.[304]

These objectives reflected Gower's belief that regulation should be no greater than is needed to *prevent reasonable people from being made fools of, but not to protect fools from their folly.* According to Gower, no regulatory system can, or should, "...relieve the investor of responsibility for exercising judgement and care in deciding how to invest his money. If he makes a foolish decision on the basis of adequate disclosure he cannot look to any regulator to make good the losses arising form his own misjudgement."[305]

The White Paper highlighted the responsibility of the investor in looking after himself; arguing that regulation should give prominence to principle of caveat emptor. However, it also argued that caveat emptor alone was not enough for ensuring that investors had confidence in the market. Additional measures were required to encourage high standards in the conduct of investment business.

The White Paper set out both the objectives upon which the regime was to be based as well as the principles and rules upon which it would be operationalized. The main points of the White Paper were:

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most of the ablest practitioners are too busy making money to be able to devote adequate time to the task of regulation" (Lawson, 1991, p. 401).

302 Prior to the publication of part two of Gower's report.

303 Written by the Thatcherite Norman Tebbit.

304 The White Paper, (1985), Financial Services in the UK: A New Framework for Investor Protection, (London: HMSO), pp. 1-2.

305 Ibid.

- An emphasis that consumers were served best by the free play of market forces.
- A recognition that market forces work best when markets are competitive and when consumers have a wide array of data at their disposal.
- The role of the law should be to provide clearly understood rules and principles relating to investment business.
- As a principle, prevention is better than cure. Regulation should make fraud and malpractice less likely to occur in the first place.
- A key to the success of the regime should be vigorous enforcement of a simplified investment law framework.
- Regulation should encourage the commitment of individuals in the financial services industry to high standards.
- Self-regulation should be an important element in delivering investor protection. The White Paper argues that the interests of the industry and of investors are coterminous, and that regulation should encourage the commitment of individuals in the financial services industry to high standards.
- On grounds of equity, as far as possible, there should be a level playing field of treatment between products and services competing in the same market.

The presentation of the FSA to the public in the mid 1980s was accompanied by a litany of public interest rhetoric.[306] The objectives of the regime were couched around the protection of "Aunt Agatha", the old lady who is incapable of looking after herself. She was to be protected from not merely blatant fraud, but also, as the first Chairman of the SIB, Sir Kenneth Berrill argued in 1988 "...from [the] millions of cases of apparently minor malpractice – hidden charges, conflicts of interest leading to preference of firm over client, bad advice given through over-optimism, under-

[306] See Booker and North 1995; Clarke 1986, 1995; Vogel 1986; Ross 1984, 1986; Goodhart 1989.

research, straightforward incompetence".[307] In short, the public interest demanded protection for 'widows and orphans', and they were going to get it.

The White paper offered a hugely disparate set of objectives. The proposed new regulatory regime promised investor protection, efficiency, fairness, competitiveness, promotion of confidence, flexibility, transparency, simplicity, vigorous law enforcement and self-regulation - clearly a formidable list. In order to understand the apparent confusion of the White Paper it is important to recognize that the Government was addressing three very different audiences.

First, the Government was addressing the perceived need to protect the ordinary retail investor, 'Aunt Agatha'. There was a practical policy belief that given the Government's policy programme,[308] there needed to appear to be some protections in place. The Government's attitude towards the small investor was profoundly paternalistic; indeed the very use of the term 'Aunt Agatha' evoked notions of the state looking after the ignorant, bumbling member of the public. Kenneth Berrill summed up the approach in a speech in 1987:

> It is not reasonable to expect members of the public at large, however knowledgeable they may be in other fields, to be able to make an immediate and detailed assessment of advice they receive on matters involving investment products, particularly those of a complex and deliberately diverse kind such as life assurance products.[309]

The regime would mean that "Aunt Agatha will be able to go to someone who is honest, competent and solvent and she will get a much higher level of service."[310]

Second, the Government was responding to lobbying by the industry (through MIBOC, SIB and bodies like the ABI and LOA) for Government assistance in the wake of the collapse, due to competitive pressures, of the old self-regulatory cartels.[311] The collapse of the self-regulatory cartels in the building society, banking

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[307] Berrill, Sir Kenneth. (1987) *The Financial Services Act: Necessary Protection or Over-Regulation*, (Loughborough University Banking Centre: Second Annual Lecture in Finance), p.2.

[308] Which included privatization, the selling off of council houses, of moving state welfare burdens onto the individual and of encouraging ordinary members of the public to aspire to become financial market participants.

[309] Berrill, Sir Kenneth. (1987), *op. cit.*, p.2.

[310] Betty Powell, SIB Press Spokesman speaking in 1988.

[311] The three main areas of difference between Part I of Gower's first official report and the White Paper related to (i) the practice of cold-calling, which Gower wanted to ban but which the

and insurance sectors in the period 1981 – 1983, in addition to the de-regulation of the stock-exchange (begun in 1983) aroused industry desire for state support for a new system of regulation to replace that which was being destroyed by competitive pressures.

Third, the Government was addressing the professional City markets which were undergoing dramatic change in the run-up to Big-Bang on 27 October 1986. In 1983-1984, so John Ellis argued,

> ...the Government got involved and really changed it all again – they got very excited by the idea of lots of foreign investment in the City – and for the City of London to be successful they needed proper regulation, to provide a framework for all of this to take place successfully...So there was a White Paper in 1985...and it was actually written by Norman Tebbit who was then Secretary of State, and it was very Thatcherite in its outlook. Self-regulation, encourage all of the markets to regulate themselves within a statutory framework and it would all be fine.[312]

The Government focused its attention on securing the place of London as a global financial centre. In order to do this it needed to have in place a regulatory regime that would symbolize the moves to clean the markets of fraud.[313] The White Paper thus emphasised the importance of the competitive position of the industry, both domestically and internationally, and argued that regulation must enhance competition and innovation in the markets. The approach was crystallized by Kenneth Berrill in a speech on March 6th 1985. He sought a system of regulation "...of a kind which suits the London markets...The job really is to help London to continue to expand as a

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Government accepted as a legitimate business practice and (ii) on the vexed issue of whether the supernumerary should be a commission or a Government department. Gower proposed that the designated agency should be a Government department but the Government accepted the industry's desire for a commission. Finally, on the issue of commission disclosure and control, Gower had advocated that a commission fixing arrangement should be part of the regime, but the Government summarily rejected this suggestion. This was largely because it couldn't possibly enshrine such a patently anti-competitive measure within the legislation itself. However, in practice the agreement was that the industry would have the freedom to establish a voluntary commission agreement to which firms could choose to join or not. In practice, the freedom of whether to join such an agreement was largely illusory as those not subscribing to the agreement would be forced to fully disclose charges and commission whereas those subscribing to the agreement would not.

[312] John Ellis, *op. cit.*

[313] Although there were already quite tough rules on conduct of business in these mainly professional markets and various forms of quite tough examinations for stock exchange members and other professional investment advisers.

major financial centre in our time zone in the period ahead, when competition for the international business gets stronger by the month"[314].

The White Paper thus encapsulated three objectives: (i) a paternalistic desire to protect the ordinary investor who was judged incapable of looking after herself in a world where she would increasingly be exposed to dealing with financial salesmen; (ii) a desire to protect the interests of the industry which wanted to reinstate a system of self-regulation; and (iii) part of a wider mercantilist policy directed at the protection and promotion of the professional London markets as a safe place to conduct business.

9. Lobbying in Parliament

Over the next year, two contemporaneous processes acted to put the flesh onto the skeleton[315] of the FSA regime. The first was the public process of debate and discussion in Parliament, over the founding principle of self-regulation, the scope of the regime, on the powers of the designated agency, the issue of legal immunity for the regulators and finally over the specific rules of the designated agency. The other was a private course of deliberation, managed by MIBOC, on the specific rules to be applied to the marketing of investment products. The cogitations of MIBOC in brokering deals between rival industry factions had a fundamental role in shaping the rule-book of the designated agency and thus in shaping the character of the entire regime.

The Debates in Parliament

Throughout 1986 debates raged in Parliament over the fundamental issue of the desirability of self-regulation as a founding concept of regulation. There was sustained pressure from the opposition parties, from consumerists, from the media and from the trade unions[316] for the designated agency to be a *de facto* independent statutory commission along the lines of models adopted in other countries[317]. The

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[314] Reported by Barry Riley, *Financial Times*, March 7th, 1985.
[315] The skeleton which was provided by Gower and formalized in the White Paper.
[316] See, for example the *Financial Times*, 24 April 1984, "TUC advocates legal safeguard for investors".
[317] The most commonly cited example being the SEC in America, but there are also examples from New Zealand, Hong Kong and Australia.

focus of the Opposition's attack on the Government's proposal to reinstate self-regulation under statutory supervision was on the alleged failure of self-regulation within financial services. As Labour MP John Whitfield stated in Parliament, "Self-regulation is a fine concept, but if the present system worked well, we should not be debating the Bill."[318] John Smith expressed the mood with great clarity: "...the trouble with too much self-regulation is that it can be turned too easily to self-protection...Anyone who can speak as blandly about the merits of self-regulation, after having seeing what some of these self-regulators have done in their own interests, is someone who is not taking a grip of the realities of the situation"[319]

Concern over the self-regulatory element of the regime was heightened by the limited powers of the designated agency over the SROs. The designated agency would have no power to interfere in the rule-making of the SROs as long as the rules of the SROs offered equivalent protection to those of the SIB.[320] The only remedy available for the SIB was the so-called nuclear deterrent of de-recognition; and yet it was generally considered that this option would not, in practice be utilized.

Whilst the Opposition failed to achieve their ultimate objective of making the designated agency a fully statutory independent commission[321], they *were* successful in winning for the designated agency considerably more powers than the Government had originally envisaged. Instead of being a private body delegated with regulatory responsibilities, the designated agency was given extra powers to investigate and prosecute miscreants under the Act. This was a highly novel arrangement; SIB was a private body but was also a criminal prosecution agency.[322] A particularly unusual facet of the legislative process was the role played by both the SIB and the fledgling

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[318] John Whitfield, Financial Services Bill Second Reading debate, January 14, 1986, Hansard, p.997.
[319] John Smith, Financial Services Bill Second Reading debate, January 14, 1986, Hansard, p.954.
[320] The SIB's rules having received approval from the Secretary of State.
[321] The SIB itself was a powerful force against being made into a statutory commission; a significant and arguably overwhelming rationale for this was that as a statutory agency it would be limited to civil service pay scales (Black, 1997).
[322] The novelty of the arrangement was recognized in the White Paper. It stated that "[t]o provide for a statutory power of authorization and regulation to be given to a private sector body is unprecedented" (White Paper, 1985, para. 5.7). Theoretical safeguards were therefore put in place: (i) members of the Board of the SIB were to be appointed by the Governor of the Bank of England with the agreement of the Secretary of State, and the Chairman of the SIB was to be appointed by the Secretary of State with agreement of the Governor of the Bank of England; (ii) all rules of the SIB and SROs would be subject to competition assessments by the OFT; (iii) the Secretary of State would retain some powers to revise of revoke the rules of the SIB or SROs if they were contrary to international commitments of unduly anti-competitive; (iv) the Secretary of State would retain powers to withdraw authorization from the designated agency; (v) the SIB would be required to lay an annual report before Parliament;

SROs in lobbying the Government for amendments. As Black states "For their part, SIB and the SROs sought, and fought, a number of amendments, largely successfully. The unusual regulatory structure gave rise to the relatively rare situation of the agency itself being a lobbyist in the formation of the legislation which would endow it with powers."[323] The influence of the SIB as a lobbyist was evident in the establishment of a central compensation scheme and in the granting of the power to revoke or amend SRO rules without having to seek court orders if they were considered to fail to provide equivalent protection.

The Scope of the Regime

Parliament also debated the scope of the regime. There were two key debates on this. One related to the Government's desire to exclude Lloyd's insurance market, mortgages and the Take-over Panel from the scope of the Act. The other related to the extent to which non-financial firms would have to be authorized in order to conduct investment business as a minor and peripheral element to their affairs.

The Opposition parties argued that Lloyds and mortgages should be included within the scope of the Act. John Smith argued that he found it, "...frankly incredible that at this stage...Lloyd's is to be specially excluded from the provisions of the Bill. We have seen more fraud at Lloyd's in the past two or three years than I hope took place in the whole of its previous history. We saw, for example, £39 million disappear with Alexander Howden, £38 million in the Mint Holdings Affair..."[324] The Government resisted both of these pressures, arguing not too plausibly that self-regulation at Lloyds was working and that as mortgages are technically liabilities[325] rather than investments they could not be included within the purview of the Act.

Despite the pressure for the scope of the regime to be widened, the scope of the definition of 'investment business' already went way beyond what most people in the industry had expected. In its initial form the Act was to encroach on wide-ranging and very disparate segments of the industry. The potential impact of the Act, particularly on non-financial companies, generated immediate and extensive lobbying. The original definition of what constituted investment business would have meant that

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and (vi) the decisions of the SIB and SROs on authorization and on disciplinary matters would be referable to an independent tribunal appointed by the Secretary of State.

[323] Black, J. (1997) *Rules and Regulators*, (London: Clarendon Press), p.64.

[324] John Smith, Financial Services Bill Second Reading debate, January 14, 1986, Hansard, p.951.

a very enormous number of firms would have to be authorized; which would have had a significant impact on their costs. Vociferous lobbying succeeded in winning amendments that excluded almost all of the non-financial companies and for those few not excluded the facility of the 'permitted person' provided a low cost solution (Aldwinckle, 1986).

Legal Immunity for the Regulatory Bodies

There was also vigorous debate over whether the designated agency and/ or SROs should have legal immunity from legal action by investors. Whilst there was general agreement in the House that the SIB as designated agency should be immune from legal action, there was no consensus as to whether the SROs should also have legal immunity. In fact, initially the Government had argued against legal immunity for the SROs. It was then gravely embarrassed when industry lobbying, especially by the only well organized SRO, ISRO forced it to make an about-turn and support legal immunity for the SROs. The Opposition exploited this example of the influence of the industry to its full. Paddy Ashdown provided evidence to this effect:

> We know that a letter was sent to the Minister on 16 April 1986 from the six nascent SROs – AFBD, IMRO, ISRO, LAUTRO, NASDIM and the stock exchange – which contained a thinly veiled threat. They wrote: 'Failing to grant immunity from these liabilities in the Bill will discourage the formation ...of SROs in the first instance, as well as compromise their operation if they decide to seek recognition.[326]

This was a prime example of the industry, through the newly formed SROs, dictating to Government and Parliament the construction of the FSA regime.

The Rules

Finally, there were heated exchanges over the extent to which the rules should be determined by Parliament or by the designated agency and SROs. Opposition members of the Parliamentary Standing Committee (and others) were concerned with the power of MIBOC/ SIB to determine rules on the key issues of disclosure, duties

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[325] Mortgages being loans to buy residential property rather than investments.
[326] Mr Paddy Ashdown, Financial Services Bill Second Reading debate, June 11, 1986, Hansard, p.416.

of advice[327] and polarization. Indeed there were attempts to insert amendments that would, among other things, have imposed duties to disclosure commissions and charges upon life office employees and salesmen.[328] However, the Government fought off the attempts of the opposition members of the Standing Committee to constrain the powers of the designated agency. MIBOC itself played a key role: "...the skills of MIBOC have been more apparent in fighting off the proposals of members of the Parliamentary Standing Committee that would have forced life companies and salesmen to reveal their costs, charges, and commissions."[329]

More Financial Scandals Occur

During the later stages of the Bill's passage through Parliament further financial scandals occurred[330] which combined with much industry lobbying to result in a very large number of Government amendments being tabled[331]. Gower was extremely critical about the Bill's passage though Parliament.

> The Act started life in December 1985 as a modest Bill drafted as well as one could possibly have hoped for under a procedure in which the draftsman knows nothing about the subject matter until he receives voluminous written instructions based on policy discussions in which he has played no part. It then had 166 clauses, 13 Schedules and was 174 pages long. In June 1986 it emerged from the Commons virtually unscathed though it had grown to 177 Clauses, 15 Schedules and 213 pages. In the course of the later stages of October and November it grew, mainly as a result of Government amendments put down to placate powerful pressure groups and drafted in unseemly haste, to the final 212 sections, 17 Schedules, and 289 pages. The result, not surprisingly is an Act of great complication and frequent obscurity. Particularly is this so in relation to the all-important Schedule 1 which defines 'investments' and 'investment business[332].

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[327] In terms of the rules on best advice.
[328] Amendment number 69, moved by Mr Anthony Nelson. Hansard, June 12, 1986, p.581.
[329] *Financial Times*, July 1986, "Men and Matters: That's Life".
[330] Including the collapse of McDonald Wheeler in 1986, where investors found that their 'safe' investments included yachts and hotels, and Barlow Clowes which started to come to light in 1986/1987.
[331] Mark Boleat commented "Whilst the act was going through Parliament there were a few scandals – at Lloyds which of course is not covered by the Act -, Barlow Clowes, Warburgs. And when that happens and the Bill is before Parliament, everyone says "Oh, we must do this.." And the minister says "Yes, we'll put all that it." So the act ends up being very different from what was intended. "
[332] Gower, L. (1988), *op. cit.*, p.20.

Sir William Clark pleaded that, "...there has been too little time for us to consider the amendments and new clauses. The Government are pushing the working of the House too hard."[333]

<u>The Influence of Private Interest Lobbing</u>

The passage of the FSA through Parliament illustrated the potential for private interests to have a major influence over complex legislation of this kind. The influence of lobbyists was pervasive, and they were able to exploit the widespread ignorance of both the general public and of the majority of the members of Parliament to significantly influence the Bill. A number of the larger financial services conglomerates even had teams of barristers working full-time on the Bill for more than a year, and trade associations like the ABI engaged in relentless lobbying. This industry effort to influence the Bill in its favour was more than a match for the poorly resourced consumer groups who were trying to argue the consumer case, and the inevitable result was that in terms of the scope, the structure, the rules and the over-riding self-regulatory character of the regime, the industry was successful in getting its way. Commentary in the press on the passage of the Bill was very interesting:

> ...those regulations soon came under fire from MPs as being concerned less with the protection of investors from insurance salesmen than of salesmen from investors. The underlying argument here has been that, although self-regulators who are practitioners may be well placed to enforce a rule-book by investigating the malpractice's of their members, they should not be asked to write the rule-book as well.[334]

The Bill allowed exactly this, namely the industry was allowed to write the rules by which it would regulate itself.

10. The Rules: A Public Interest Smoke Screen

Whilst Parliament deliberated over the structure of the regime[335], MIBOC[336], the body set up in 1984 and headed by insurance entrepreneur Sir Mark Weinberg, was

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[333] 11 June 1986, Hansard, p 386, vol 99 col. 386.

[334] *Financial Times*, September 26, 1986 "Adrift On A Sea Of Small Print / Report on the Financial Services Bill".

[335] The head of Nat West's pensions unit, Joanne Hindle had fond memories of these debates: "...the Parliamentary debate at the time was fascinating. I remember one debate in the House of Lords, on whether the Act was going to catch the chap who had a chat to another chap at the golf club and said

endowed with the task of formulating specific rules for the marketing of investment products. MIBOC offered a series of regulatory measures that would ensure Aunt Agatha's protection[337]. They were presented in starkly public interest terms.

The Rationale for Regulation

The most commonly articulated arguments for the regulation of retail financial services relate to the existence of market imperfections. It is often stated that financial services products are in some way 'special'.[338] The implication of these market imperfections was that the investor faced grave difficulties in making informed investment purchasing decisions. In Berrill's words, "...it is not reasonable to expect members of the public at large, however knowledgeable they may be in other fields, to be able to make an immediate and detailed assessment of advice they receive on matters involving investment products, particularly those of a complex and deliberately diverse kind such as life assurance products..."[339] Aunt Agatha was thus forced to be overwhelmingly dependent on the quality, clarity and impartiality of the advice being given by the adviser. However, a number of factors cast serious doubt on the quality and impartiality of the advice that she was likely to receive.

The Opacity of the Contractual Relationship

There were problems related to the ability of the investor to identify the adviser as being either their agent or the agent or employee of the insurance office. This distinction is of critical importance. Where the salesman acts as 'agent' of the consumer, he will owe fiduciary duties to secure what is in effect best advice for the client (principal). However, the insurance company employee/ representative had only a duty of promoting the interests of his employer. A number of factors made determining the status of the adviser problematic.

"I've got some promising Far Eastern Units." Was the Act to cover this type of advice as well? I mean, oh God!" Parliament also debated whether precious coins and stamps should be included within the regime.

[336] The Marketing and Investments Board Organizing Committee.

[337] Although the process of converting the nebulous objectives of the White Paper into solid legislation that was acceptable to the industry was far from straightforward. As John Ellis, a senior official on the MIBOC board confessed "he [Weinberg] chaired it and I was the secretary to that committee [MIBOC]. We tried to do the retail end of the business. I think, there we were six of us on the committee, nobody really knew what to do...[W]e took on an ex DTI lawyer, he said, 'I know what to do' so we said 'Yes, okay, go and do it!' And he started drafting an enormous rule book..."

[338] See Llewellyn 1995; Goodhart 1989; Gowland 1989.

[339] Berrill, Sir Kenneth, (1987), *op. cit.*, p.2.

The first was the potential confusion caused when investors could be visited by seemingly identical advisers, but depending on which one they decided to contract with, the legal relationship (the duties owed) would be fundamentally different. This problem was made worse because much insurance selling has traditionally been done by speculative approaches to members of the public either by door-to-door visiting (cold calling) or by telephone sales.

A second factor relates to the *dual agency* characteristic of the insurance contract. The transaction costs of dealing with professionals often precludes the splitting of the 'advising role' from the 'acting role', thus, dual agency is a common phenomenon in contracts between consumers and professionals. The dual agency nature of the insurance contract is highlighted best when investors choose to contract through IFAs. When diagnosing the consumer's problem (financial need), and suggesting remedial action, the 'independent' adviser acts as the agent of the investor. He thus owes duties under the law of agency to the investor to disclose his earnings and incentives. He also, of course will owe duties of disclosure under *uberrimae fidei.* However, when actually executing the prescribed action the adviser acts as principal in carrying out the recommended action. Thus, at different times during the sale, there can be a fundamentally different legal relationship between the client and IFA. This need not be a problem for the investor, as long as there is disclosure and transparency.

However, before the FSA, the practice was for neither type of adviser (Independent[340] or company agent) to declare their status. Not only was this 'non-disclosure' a serious barrier to investors being able to make informed decisions, but it was also a breach of the common law. Independent advisers should have disclosed commissions, their status (as the agent of the consumer) and have discharged their fiduciary duties under agency law (such as to disclose their remuneration). Company representatives meanwhile should have disclosed commissions, charges and their status under the common law of uberrimae fidei. The fact that neither did was a testament both to the power of the industry and to the failure of DTI regulation[341].

This widespread failure by advisers to disclose their status was not only confusing to the consumer but could also conceal a potentially serious conflict of

[340] IFAs were then known as 'Brokers' and had to pass Chartered Insurance Institute examinations. Later they were required, under the Insurance Brokers' (Registration) Act 1977 to be registered and vetted.

interest. This occurs where a supposedly independent adviser recommends action that is in his interests as principal rather than in the interests of the consumer.[342]

A further factor compounding the complexity of the client/ adviser relationship was the practice in many institutions of effectively operating multi-tie arrangements. Multi-ties involved firms engaging in informal agreements with a limited number of product providers[343] and selling only the products of those providers. The criteria on which the hosts were chosen stemmed more from "...soft issues such as the personality of the local representative of the provider, rather than 'hard' issues such as the quality of the adviser itself".[344] Whilst advising on a limited range of products they were able to give the impression that they were actually giving independent advice.[345] In a survey conducted by the Office of Fair Trading (OFT) in 1986, over a quarter of intermediaries were found to be advising on six or less companies' products and only 9% of intermediaries used 25 or more. A whole manner of different tying arrangements existed. Perhaps the most confusing to the investor was the arrangement whereby self-employed direct salesforces were tied to one company but were also free, in certain circumstances to recommend non-tied products.[346] These advisers held themselves out as only recommending their host's products if these were best for the consumer.

These and other confusing arrangements infuriated those advisers who claimed to be offering 'genuine' independent advice and, (according to these groups) was mis-leading to the investor. What is clear is that this practice of operating 'in the middle' further confused the issue of the status of the adviser, and consequently caused confusion over the incentives under which the adviser was making recommendations.

Commission Bias

The problem of commission bias cast yet further doubt on to the impartiality of the advice that Aunt Agatha was likely to receive. The practice of remunerating and

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[341] Insurance companies were regulated by the DTI under the powers of the Insurance Companies Act 1982, and brokers were regulated by the DTI under the Insurance Brokers' (Registration) Act 1977.
[342] This is similar to cases where dentists recommend costly treatment in the knowledge that they will benefit financially from carrying the treatment out.
[343] Often as few as three or four.
[344] The Halifax, (1998), p.2.
[345] That the providers had been selected on some independent basis.
[346] For instance after meeting a certain quota of sales for their host provider.

motivating financial advisers by the payments of sales-related commission was ubiquitous[347] in the retail financial services industry. There were two principle examples of commission bias.

One of these was where independent brokers allowed the differential levels of commission available on different products to affect their investment advice to consumers. There are two potential opportunities for commission bias to occur: (i) the adviser can earn more commission by recommending certain product types over others. So, for instance an adviser will earn more commission on a *regular premium* insurance policy or pension than on a single premium policy. The adviser will also earn considerably more commission by recommending an interest-only mortgage, supported by an investment product than recommending a repayment mortgage[348]; (ii) investment advisers can earn higher commissions by dealing with high paying life offices. Commission bias suggests that despite fiduciary duties to provide impartial advice as the agent of the investor, the adviser looks to further their own private interest by maximizing commission earnings. As the OFT summarized in 1987, "Impartiality of independent advisers cannot be guaranteed if their recommendations are influenced by the extent of the benefits that will flow to them from recommending one policy rather than another."[349]

Commission based remuneration[350] also raised the suspicion that there was a distinct bias to over-selling within the industry. Within firms, sales-managers' remuneration was based – to a substantial degree – on their monthly sales figures, and their salesmen were remunerated - often entirely - on the basis of their monthly sales-performance. If sales were below the company targets then sales-managers would be sacked. On the other hand, if sales were good, but some mis-selling occurred, the sales-manager could reasonably expect to have moved up or out by the time problems came to light. Thus the method of remuneration for sales-managers and for sales-men created an incentive to maximize sales, regardless of the interests of the investor.

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[347] This involved the availability of different amounts of commission from different product providers and also different levels of commission by product providers on different products within their range.
[348] An adviser can earn typically £800 for recommending an interest-only mortgage against £40 - £50 for a repayment mortgage.
[349] OFT, (March 1987).

Information Asymmetries and the Quality of Advice

Insurance contracts are also plagued with information asymmetries that can make it difficult for investors to determine the quality of the advice they are receiving. The superior knowledge of the insurance salesman/ adviser means "customers will often not be in a position to make an informed estimate of the calibre of the advice and services of the professional".[351] This problem is compounded by three other factors, which make it even more difficult for investors to make informed judgements on the quality of advice.

The first is that financial services products are inherently complex and are non-homogeneous. It is thus difficult for the majority of investors to understand or evaluate the quality or suitability – even at a very superficial level – of the products on which they are being advised. This complexity leads to the second problem: It is difficult, if not impossible for investors to make meaningful comparisons between products. The quality of financial products is inherently subjective and thus can only be determined by reference to some comparative data. In financial services these comparative data are largely unavailable. Finally, the time-scale over which financial products mature is often twenty years or more, and this means that by the time the investor is able to make judgements on the quality of the advice given it can be too late to do anything about it.

The imperfections inherent to the insurance contract mean that despite the quality of advice duties owed by advisers to the investor, it is very difficult indeed for the investor to determine whether these duties are actually being met.

'Destructive Competition'

Another problem concerned the absolute level of commissions within the industry. There was a general belief within the industry that if commissions were not centrally controlled[352] a damaging commissions war would ensue where life offices would compete for distribution by offering higher commissions to advisers. The industry argued that the imperfections in the market for financial services meant that competition was not for the custom of investors per se but was for distribution. It was

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[350] Coupled with the employment of vast direct sales-forces by many of the life offices from the 1970s through the 1980s.

[351] Goodhart 1989, *op. cit.*, p. 207.

[352] By a cartel or by Government.

thus argued that in the absence of controls on commissions, unrestrained competition would lead to a commissions war where life offices would bid up commission rates to the advantage of no one except the intermediary. It was argued that the public interest demanded statutory control of commissions.[353]

MIBOC's Recommendations

In sum, there were: (i) problems related to the lack of status transparency (information asymmetry problems); (ii) problems related to the conflicts of interest created by the widespread use of commission based remuneration; and (iii) concern that in the absence of controls on commission levels, a commissions war would ensue and commission levels would be bid up to the disadvantage of the investor (imperfect knowledge problems). These problems combined with an industry where the salesmen (with the exception of registered brokers) were largely untrained and unprofessional. Consequently, consumers could not determine the quality of the advice given (because advisers did not conform to common law requirements of disclosure), the majority of advisers were untrained, and the potential rewards from deception were very considerable (Clarke 1986, 1994d). The financial services industry was therefore uniquely placed to mis-sell products to investors.

Weinberg made a number of recommendations to deal with these problems.

Polarization

To clarify the status of the adviser, Weinberg proposed the principle of *polarization*. Those offering advice on life assurance, unit trusts and certain other packaged investment products were to be obliged to choose their status. They would choose between offering advice as the agent of the investor, on the whole range of products available on the market – thus undertaking (amongst others) the duty of exercising due skill, care and diligence with a view to securing the best bargains for the client - or offer advice as the employee or agent of a life office and thus provide advice on only the product of that insurance company. The adviser would also have to disclose

[353] See Gower 1984; Jebens 1995; Weinberg 1988.

its status to the investor. Thus, in theory the investor would be able to identify who they were dealing with.

For the adviser who chose to be a tied agent, he must only advise on the products of the one company (to which he is tied), and his duty, under the rules of 'suitability' and 'best advice' was to advise on the most suitable product from his company's range of products for the investor's needs[354]. However, if the adviser was an independent adviser (an IFA) he was expected to advise on the whole range of products on the market and had a duty to find the 'best' product on the market. To do so, under the principle of 'know your customer', he must examine in great depth the financial circumstances of the investor (through a process called a 'fact-find') to determine the 'best' possible product.

Disclosure

Weinberg also proposed a system of limited disclosure for IFAs, so called *soft-disclosure* in order to tackle the problem of commission bias. Initially the requirement was that if an IFA was a signatory to an industry wide commission agreement, and was receiving a level of remuneration that was within the limits of this agreement, the IFA had only to disclose this fact (that he was paid by commission and that it was within the limits of the MCA[355]). However if the IFA was paid a level of remuneration above the MCA ceiling, he would be required to disclose both this fact and the level of the commission at point of sale (hard disclosure). If the IFA was not within an industry commission agreement, then hard disclosure of commissions was always required.

Initially there were no disclosure requirements for the tied agent. The rationale given was that because the tied agent was only allowed to sell the products of one product provider, there would be no possibility of the decision being influenced by the level of remuneration. In fact this was a fallacious argument, as different products (for instance regular premium as opposed to single premium life products) provided different levels of commission to the tied adviser. There is also the wider issue of whether the investor is able make comparative judgements on value for money.

[354] The 'best' product from that company's range may be substantially inferior to the products of another supplier but the adviser has no duty or indeed right to advise on these other products.
[355] Details of the MCA were available on request to investors.

Disclosure of charges, expenses, and commissions is essential in order to make such comparative assessments possible.

This proposal of MIBOC caused controversy on two fronts: (i) in the industry where accusations were made that the tied agents would receive an unfair competitive advantage from the disclosure rules, and (ii) in Parliament where many MPs felt that full disclosure for all salesmen should be adopted.

In the face of considerable opposition to the MIBOC proposals in Parliament, Michael Howard was forced to act. He therefore asked MIBOC to reconsider its proposals making it clear that many MPs were in favour of full disclosure of commissions paid to salesmen, disclosure of the proportion of premiums retained by life companies for expenses, and the penalties imposed on the investor on surrender during the first few years of the contract. However, SIB and MIBOC, came out against the MPs' favoured approach of hard disclosure and they were joined by the ABI which argued vociferously against the hard disclosure line[356].

The essence of the ABI's argument was that people were mis-understanding the nature of the with-profits insurance policy. These policies are based on the pooling basis of insurance – all premiums paid by investors are placed in a common fund from which is drawn the cost of running the fund. The remaining funds are then invested on a common basis and the resulting profits are allocated to policy-holders equitably, based on the advice of the life assurer's actuary. The ABI argued that pooling made it impossible to determine the costs and expenses associated with each investor's policy. Thus, they argued that the best policy was to give investors information on surrender values – which, coincidentally, was what MIBOC was recommending. Weinberg made his position clear in a speech to the Scottish Insurance Brokers on September 22, 1986, in which he claimed that disclosure of expenses of insurance companies on with-profits polices would "not help the investor in making an investment decision"[357]. MIBOC, in response to considerable industry lobbying, resisted the MPs' demands for hard disclosure and recommended that its original proposals be adopted. MIBOC essentially argued along the lines of Professor Gower that disclosure was only required for independent agents. As far as company agents were concerned, the task of calculating expenses and charges for products sold by them would be very

[356] The ABI become an expert at lobbying even creating a fact-sheet which was sent to all peers, MPs and other bodies.
[357] Financial Times, September 23, 1986, "SIB Rejects Disclosure of Expenses by Insurers".

difficult and that even if it were possible, the data would be misleading and not easily understood by investors.

Best Advice and Suitability

In addition to the rules on polarization and disclosure discussed above, the principles of 'best advice' and 'suitability' were proposed by MIBOC in order to offer guarantees on the quality of advice that Aunt Agatha would receive. The requirement of suitability (SIB rule 5.01) was that "a firm should not recommend a transaction to a customer unless it is suitable for that customer's needs and circumstances." This applied to both independent advisers (agents of the investor) and company representatives, and carried with it a clear requirement that the adviser (whether tied or independent) researchers the 'needs and circumstances' of the investor.

The duty of 'best advice' was an additional duty and applied differently to independent and tied advisers. For the adviser who is the agent of the investor, 'best-advice' laid down a number of requirements. Most importantly it required that the independent intermediary must not recommend a product if '...the same or another life office... would or might be willing to enter into a transaction with the customer which is likely to secure his investment objectives more advantageously...' (SIB rule 5.03). This implies two further duties on the IFA: (i) of researching the whole market in order to be sure that no other deal would '...secure his investment objectives more advantageously...'; and (ii) to research fully the circumstances of the investor in order to determine what, exactly the '..investment objectives...' of the investor are. The SIB principle of 'Know your customer' was a coterminous duty, which laid down specific arrangements for the achievement of best advice. The 'Best advice' rule imposed a further duty on the independent adviser. If the IFA was a subsidiary or associate of a life office, it was only permitted to recommend the products of the associate or parent life office if it was able to show that their host's product was 'demonstrably better' than the alternatives. In these circumstances the IFA was thus required to exercise positive discrimination *against* its associated life office.

For the tied adviser the principle of best advice applied somewhat differently. The duty of the tied agent was to recommend the most suitable product from his host's product range. The adviser had no duty (or indeed right) to offer advice on the products of any other life office. However, the adviser could only recommend a product if it reasonably believed that there was '...no other investment which would secure that person's investment objectives more advantageously' and which 'the firm or any other regulated life office....in the same marketing group would or might be willing to provide.' (SIB rule 5.02). The duty of best advice for the tied agent was thus to recommend the 'best' product from the range of products that he was at liberty to sell under the conditions of the tie.

In order to enforce these duties of advice, the concept of the audit trail was applied. This required that the firm should be able to prove categorically that all reasonable steps were taken to comply with best advice (and with the associated 'know your customer' duty). In the case of a dispute, a failure to be able to prove that best advice was given (by the production of records) would count as a failure, not only of record keeping but also of best advice.

Commission Fixing

In order to combat the potential for a commissions war, the system of polarization (outlined above) was accompanied by a system of commissions fixing (run by one of the SROs, Lautro). Under the Maximum Commission Agreement (MCA), a ceiling was established for the amount of commissions that could be paid to advisers. Any intermediary being paid a level of commission above the MCA would have to fully disclose the amount of the commission to the investor (thus a clear incentive was established to stay within the MCA). The MCA was not actually a feature of the Act itself, for whilst Gower recommended the statutory control of commissions (Gower 1982, 1984), the Government took the view that commission levels were a commercial matter and not a matter for Government intervention (Gower 1988).

SIB, with the consent of the Government therefore made it a condition that an IFA had to disclose the level of commission that they were paid, *unless* a voluntary industry commissions agreement was in place. An agreement was established and almost all companies subscribed to it. Weinberg thus offered polarization, 'soft' commission disclosure for IFAs, best advice/ suitability rules, and commissions fixing as an ingenious investor protection package. Aunt Agatha would be able to sleep soundly in the knowledge that she was protected by these central pillars of regulation – she would know the status of the person she was going to for advice and she would, if she was willing to pay for it, have access to genuine independent advice (with a guarantee that she would receive best advice), free of commission bias. Furthermore, the commissions fixing agreement would also keep commissions down; this was also – supposedly - in the interests of Aunt Agatha.

Despite the apparent public interest credentials of MIBOC's recommendations, in truth they had more to do with the interests of the industry than of the investor. The private interest origins of the MIBOC proposals are now considered.

11. The Rules: Private Interests Take Over

Throughout the extensive consultation process on the Financial Services Bill, the insurance industry lobbied vociferously on two grounds.

The first of these was that the industry was adamant that it should not be forced to disclose commissions, charges and expenses.[358] The insurance companies argued that disclosure of charges and commissions was not essential for investors to make informed decisions (not in the *public interest*). Furthermore, they argued that there were formidable barriers to meaningfully calculating the charges associated with individual policies, particularly where *with-profits* policies are concerned where premiums are pooled[359].

The second area of industry lobbying was by the old established insurance companies. These were concerned that new insurance companies were entering the market and were capturing market share by paying higher commissions to advisers[360]. These new firms, many of whom entered the UK market from overseas, engaged in a practice of cartel busting. This caused the collapse of the industries' commission fixing agreement (run by the two main professional organizations, the Life Offices Association (LOA) and the Associated Scottish Life Offices Association (ASLO)) on 1 January 1983. By staying outside the industry commission agreement the firms had been able to capture market share by paying higher commissions to advisers.

Following the collapse of the LOA/ ASLO commission fixing agreement, in late 1983 eighty large life offices attempted to establish a Registry of Life Assurance

[358] See Ross 1984, 1986; Goodhart 1989; Jebens 1996.

[359] Mark Weinberg was persuaded by the arguments of the industry and of the ABI in particular against disclosure, announcing in a speech to Scottish insurance brokers in September 1986 that disclosure of charges on with-profits life policies would not "help the investor in making an investment decision." (*Financial Times*, 23 September 1986, 'SIB rejects disclosure of expenses by Insurers').

[360] Jebens, Sir Kit. (1996), *op. cit.*

Commissions (ROLAC) to operate a scheme for maximum commissions in the life assurance industry. Events overtook the ROLAC scheme, but its purpose was clear; to prevent competition on commissions that was allowing innovative firms to capture business. The life offices did not like the prospect of a substantial increase in their costs of distribution and so lobbied for Government assistance.

The industry, dominated at this time by the life offices thus had two demands. Their first was that they should be excluded from any requirements to disclose the costs of their products[361]. The industry opposed disclosure requirements vehemently because they would expose the poor value of the products that they were providing. The second was that they required a maximum commissions fixing agreement. If Government supported and policed such an agreement it would be much harder for firms to break it.

Weinberg, the man endowed with the duty of taking the decisions on these matters, was a regulator with very strong sympathies for the life office side of the industry, having set up Hambro Life, Abbey Life and Allied Dunbar. After consultation with the industry, Weinberg found himself persuaded of the merits of the insurance industries' arguments for a maximum commission fixing agreement and for very limited disclosure. However, Weinberg had to persuade the 15,000 or so independent brokers[362] that a maximum commission agreement (MCA) was desirable. Commission fixing was unpopular with the IFAs (brokers) because it would effectively place a ceiling on their incomes[363]. If he was to get their support, Weinberg would have to offer the IFAs something in return.

In order to win the IFAs over, Weinberg offered them *a fait acommpli* whereby those operating 'in the middle' as multi-ties would be forced to choose between being tied to the products of one life office or offering advice on the full range of products on the market (i.e. polarization). This was popular with the IFAs for several reasons: (i) it would mean that the concepts of 'independence', 'independent advice' and of course of the value of independent brokers would be a central theme of the new regime and the promotion of it; and (ii) perhaps more importantly it would

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[361] Although they were happy to drop the IFAs in it, by arguing that *they* should be disclosing commissions.

[362] IFAs have a reputation for their independence of mind and candour.

[363] A Maximum Commissions Agreement would prevent a commissions war which the life offices were terrified of. Of course, the IFAs, would be the beneficiaries of such a commissions war and were thus opposed to commission fixing.

prevent the high street institutions from operating in the middle ground. If banks and building societies were allowed to do this (i.e. operate in the middle-ground), and effectively offer the best of both worlds (offering advice on a range of companies' products at a lower cost than the IFA who had to chart the whole market) then many saw little future for the independent sector. The IFAs thus accepted the deal and polarization was borne[364].

Polarization was thus born, not through a desire to correct market failures or out of genuine 'public interest' concern for the interests of Aunt Agatha, but to serve the desire of the industry to fix commissions and to avoid disclosure, and for the IFAs to diminish competition.

The principle of polarization, the MCA and disclosure rules arose out of rent seeking by industry groups. Had the Government been concerned only with the market failure problems outlined above, it could have come up with more straightforward remedies. Polarization could have been replaced with a straightforward requirement for status disclosure[365]. The MCA could have been replaced by genuine product disclosure, which would have allowed consumers to make informed decisions and to exert competitive pressures on the levels of commission. However, neither of these policies benefited the industry and so they were rejected.

Whilst the industry managed to lobby for regulatory benefits, the Government also had demands. It required a regime that gave cast iron guarantees on the quality of service that Aunt Agatha would receive. The Government needed to persuade the ordinary investor that financial salesmen and advisers were trustworthy – it also needed to be seen to be imposing tough requirements on the industry. The principle of 'best advice' symbolizes these goals more profoundly than any other.

Best Advice was a highly controversial feature of regulation, considered by many to be practically meaningless given the huge range of highly differentiated products on the market. However, it is clear that the concept of best advice served an

[364] Ironically the MCA agreement soon ran into trouble with the Oft, European Union Directives and the Government and was ended in 1989.
[365] As the Director General of Fair Trading argued in his rather critical review of the SIB/ MIBOC rules in 1987. The purpose of the rules on polarization is to "...seek to ensure that there is no misrepresentation of impartiality. But these rules are not the only possible route to this objective; a requirement to disclose a tied agency ... would also achieve that objective and would not have the disadvantage of reducing the range of different companies' policies that the 'middle ground' is now able to offer, with the degree of competition that that provides" (OFT, 1987).

important function. The public interest symbolism of the FSA was crystallized in a single concept and an official stamp of approval was placed on financial advisers and salesmen; Aunt Agatha would be able to get 'best advice'. It offered a seemingly cast iron guarantee on the quality of advice that she could expect to receive.

12. The Bill's Royal Assent and SIB's Rule-Book

After a tortuous passage through Parliament, the Financial Services Act received its Royal Assent in November 1986. The designated agency under the Act (the SIB) published its rule book or 'Conduct of Business Rules' in February 1987 and was formally approved as the designated agency in May 1987. The rule-book, a hefty document to say the least, ran to a hundred and thirty six Pages and covered sixteen separate categories. SIB's rules formed the basis of the way in which the Act affected the day-to-day relations between the individual investment firms and their customers and strongly reflected the influence of MIBOC.

The key areas of the SIB's rules were:

- **Type of investor**

This category defined three types of investor:

- Business investor. This is someone who is not in the investment business, but in the course of their business enters into investment transactions quite frequently.

- Experienced investor. This is a person who frequently enters into investment transactions and so can be expected to understand what he is doing.

- Professional investor. This is a person or firm which carries on an investment business.

The rules which investment firms had to observe varied depending on the type of investor being dealt with.

- **Business plan**

A firm may not undertake investment business unless it was authorized by the appropriate SRO, or the SIB, which includes specific authorization of its business plan. If its business plan changed it must apply for further authorization. Very great detail is required in the plan including the type of business, the scale of business and so forth.

- **Business Incentives**

Strict rules applied as regards the incentives which may be given to obtain business. The aim is to establish an ethical code of conduct; there are outright bans on churning and on volume overriding;

- **Know your customer**

The seller had to establish what type of investor the client is, and owed a duty to obtain best execution in any deals carried out. The seller must also make the investor aware of risks involved in any investment strategy.[366] Sellers must also take reasonable steps to learn about the customer and their requirements in any investment strategy - they must learn the relevant facts about their personal and financial situation. The only instance where this rule does not apply is if the deal is made on an 'execution-only basis.

- **Customer relations**

These rules, described in detail above, included those of 'suitability' (rule 5.01), polarization (5.02 and 5.03), best advice, best execution (5.04), and rules relating to the maximum commission agreement.

- **Maintenance of records**

[366] Although this provision in the 'Know Your Customer' rules does not apply to professional investors.

There were strict rules on record keeping (16.02) so that transactions can be traced back to ensure investor protection through the *audit trail.* Records are required to be kept for commissions. Under 'know your customer' and 'suitability' sellers must keep a detailed record for each customer (16.05). Detailed records must also be kept on company representatives themselves and kept for 3 -5 years.

- **Unsolicited calls**

In general it was illegal to cold call - but there were some exceptions. Cold-calls may take place in social hours for unit trusts and life assurance or if the contract in question is to manage an occupational pension fund. Cold calls may also take place on business or professional investors. Cold-calls may also take place if it is repeat business, or if the person is already a customer and selling by this means is agreed. If a customer goes to the investment firm for other business it is permissible to attempt to sell them investment products.

- **Fees**

This section set out 27 pages on fees to be levied by the SIB on the industry.

- **Compensation to investors**

There are two key issues relating to the compensation of investors:

- The first is the potential for insurance to have moral hazard effects. Moral hazard refers to a phenomenon whereby investors alter their behaviour due to the knowledge that they are insured for potential losses. The prime example of this was the role of deposit insurance in the thrift crisis in America. Investors had any potential losses covered up to $10,000 and whilst this was designed ostensibly to make the financial system more sound, it had the effect of encouraging investors to place their money with the most risk-taking institutions.

- The second issue relates to the 'insurance principle'. If contributions to the compensation scheme were based on risk, then large firms would pay virtually nothing and small firms would carry the burden. There is no recognition of the insurance principle in the FSA compensation scheme: it is levied pro rata on the turnover of firms.

- **Arrangements for the independent investigation of complaints**

When the Bill reached the House of Lords a requirement was inserted for a system for the prompt settlement of complaints. This provoked much opposition from the industry - unit trust and life assurers were very much opposed to putting their members under the jurisdiction of an ombudsman. The complaints procedure is that the customer first had to complain to the authorized firm, which in turn had an obligation to investigate and deal with the complaint. The complaint then progressed to the relevant authorizing body - the SRO - which had a duty to investigate, and the complaint could not go further unless that investigation proved unacceptable to the complainant. The complainant could then refer the complaint to the SIB. In some parts of the City, ombudsman schemes already existed and the SIB was given the power to recognize these bodies.

The self-regulatory structure

The main duty of the SIB was to ensure that the SROs had rule books which were at least as stringent as the SIBs (the principle of 'equivalence'). Its task was to authorize SROs, RPBs and RIEs (or more formally to advise the Secretary of State on which bodies to authorize) and to monitor and supervise them.

In the period December 1987 – April 1988 five SROs were authorized; these being FIMBRA, Lautro, IMRO, TSA and the AFBD. In the period January – February 1988 nine RPBs were also recognized. On the 27th of February 1988, 'P-Day' the deadline arrived for firms to apply for membership of a relevant SRO or to SIB. Thirteen thousand firms had applied for membership by this date, one hundred and thirty-eight of these being to SIBRO, which was the regulatory wing of SIB. In April 1988 seven investment exchanges and two clearing houses were recognized. Finally, on the 29th April 1988, 'A-Day', the main provisions of the Financial Services Act came into force.

13. Conclusions: Private Interests and State Power

If the public interest theory is to be believed, regulation is an economic tool employed by the state in order to correct market imperfections that would otherwise jeopardize investor welfare: market imperfections are identified, policy instruments are designed, and these are then implemented by neutral, impartial public servants. Or this is how the theory goes. However, the origins of the Financial Services Act regime do not appear to be explained by even a very weak version of the public interest theory.

Gower was commissioned not (primarily) as an act of altruism or concern for the ordinary investor, but as an act of political expediency to deflect criticism from the media caused by a series of minor financial scandals in 1981. Moreover, once commissioned Gower quite unashamedly eschewed the application of cost-benefit analysis; principally because he doubted its value but also because there was apparently no political demand for him to consider the economics of regulation (Gower, after all, was a lawyer, not an economist). The focus of Gower's inquiry was more on tidiness that on the identification and correction of market imperfections.

Although the sentiments of those who extolled the virtues of protecting the small investor, should encourage the raising of hats in collective approval. The raising of hats is often merely preliminary to the scratching of heads. For it is difficult to characterize the political horse-trading that resulted in the final FSA regime as being the result of rational deliberations by public servants attempting to further the interests of the ordinary investor.

The influence of the investment industry on the design of the FSA regime was pervasive. From the lobbying that Gower received in 1981-1982, to the influence of the two industry dominated committees in 1984, to the extraordinary influence of MIBOC under the leadership of insurance luminary Sir Mark Weinberg, key elements of the FSA regime were substantively decided by the industry. The role of Michael Howard in fighting off the attempts of the Opposition members of the Standing Committee to constrain the role of MIBOC was a fascinating microcosm of the process as a whole. A large degree of autonomy for the industry was an essential requisite for industry co-operation, both in the designing of the regime and also, as crystallized in the founding principle of self-regulation, in the regime itself.

The extent of private interest influence on the FSA regime was considerable. The regime was a manifestation of the private use of the power and legitimacy of the state in order to insulate the industry from competitive forces (which were causing the existing system of cartel based self-regulation to collapse) and to reconstitute a system of industry dominated self-regulation. As Moran argues

> ...powerful interests in the City have carried out a considerable constitutional coup. The new system - measured by the authority given to its institutions, the resources at their disposal and the coverage of markets - is an immeasurable improvement in regulatory capacity on what went before. Both SIB and the SROs are substantially protected from the central machinery of the state.[367]

Although some, and most notably Professor Gower have attempted to deny the self-regulatory nature of the regime[368], it is clear that the FSA regime was overwhelmingly self-regulatory in nature.

The Government also reaped substantial benefits from the introduction of the new regime. To begin with, it deflected criticism for being soft on its traditional friends in the City and in 'big business'. It was also able to exploit the passing of the FSA in order to promote the City of London as a safe place for foreign firms and investors to do business[369]. In addition, by offering guarantees to investors on the quality, integrity and honesty of members of the investment industry, it was able to claim it was strengthening consumer confidence in the safety of investment firms and thus encourage investment. Finally, it was able to claim it had achieved these objectives with very little cost to the public purse; the new regime would be funded by the industry and staffed, not by civil servants, but by members of the industry. The FSA was thus a coup not merely for the industry but also, in a fundamental sense, for Government.

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[367] Moran, M. (1991), *op. cit.*, p.78.

[368] Professor Gower argued that the description of the regime as being self-regulatory "...amount almost to a confidence trick" (Gower, 1988, p.11).

[369] The Act, whilst principally focused on protecting 'Aunt Agatha' also put in place a new regulatory regime for the London wholesale markets (two SROs: The Securities Association and the Association of Futures Brokers and Dealers were established. In addition the London Stock Exchange was warranted status as a Recognized Investment Exchange) and for professional corporate investment business. The City of London had been gradually haemorrhaging business to innovative new markets

CHAPTER FIVE

The Development and Capture of the FSA Regime

1. Introduction

The preceding chapter argued that the origins of the regulatory regime put in place by the Financial Services Act were initially in a symbolic political response by the Government, motivated by the desire to deflect criticism after a series of minor but politically damaging financial scandals in the early 1980s. The scandals combined with a heightened pace of change in financial services which brought the beginning of a breakdown in the former systems of control. However, almost as soon as the process of reviewing the regulation of investment business was begun, the substantive task of constructing the regime was effectively handed over to the industry; either explicitly through committees comprised of the industry elite, or through more subtle, informal channels of influence.[370] The result was a regime which, though shrouded in the smokescreen of paternalistic concern for protecting 'Aunt Agatha'[371], was substantively designed by the industry to serve its interests. Moreover, due to the founding principle of self-regulation, the regime was in practice also to be run – at least in the early days - by the industry.

This chapter further exposes the private interest origins of the regime put in place by the Act in 1988. The role of private interests and the regulators in shaping its development up until 1997 is scrutinized. I argue that the influence of the industry was to result in a fundamentally flawed regime.

This chapter has three key themes:

- The public interest theory fails to provide a plausible explanation for the behaviour of the regulators, policy makers and the industry. The notion of the altruistic public servant inherent in the public interest theory fails to provide an

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and the Thatcher regime was anxious to stem to tide and to reassert London's place a global financial centre.

370 This is illustrated most starkly in the origins of the principles of polarization, the Maximum Commission Agreement and the rules on the disclosure of commissions and charges. The informal influence of the industry was illustrated in the previous chapter.

371 This satiated the Government's objective which was to make a symbolic stand against malpractice and fraud in investment business. The framing of regulation around the paternalistic protection of Aunt Agatha was also coterminous with a number of the Government's key policy objectives such as extending share ownership and transferring state pension burdens onto the individual.

adequate explanation for the behaviour of the regulators in a range of policy decisions.

- The public choice approach does offer some illumination for how the FSA regime developed in practice and for how the regulators behaved. For the most part[372] the self-interest of the regulators equated with the interests of the industry; the regulators were substantively, in the case of LAUTRO and FIMBRA industry trade associations, so it is perhaps not surprising that they were sympathetic to the industry's cause. However, the other regulators, the PIA and SIB whilst supposedly endowed with greater independence from the industry were also heavily influenced by it. In addition, PIA and SIB (in the early days at least) proved to be sympathetic to the industry's cause. Evidence of this derives from the regulators' resistance to tackling the industry 'head-on' on a number of issues where the industry had a strong vested interest - the issues of competency standards, commission-incentivized selling, the disclosure of information on commissions and charges and on the individual registration of salesmen.

- Finally, that on a number of key issues where the interests of the investor and those of the industry clearly clashed, the regulators took the side of the industry. They acted in the interests of the investor only when they were forced to by the Government. Furthermore, the Government's motivation for forcing the regulators to serve the investors' interests was not founded in altruistic concern for the interests of Aunt Agatha, but in the desire to deflect media criticism caused by financial scandals or perceived regulatory or Governmental failure. A prime example of this is the personal pensions imbroglio: it was intense media criticism of the regulators during the run up to the 1997 General Election that finally provoked the government, in the shape of Angela Knight and then (for Labour) Helen Liddell to intervene.

The chapter begins by considering the initial regime put in place on 29th April 1988. As public choice would predict, the control mechanisms put in place by the FSA were either (i) control mechanisms which – given the institutional structures put in place - had no possibility of being successfully enforced and so were thus, at best purely symbolic or (ii) were control mechanisms which offered clear and manifest benefits to industry interests. In addition, there is considerable evidence that control mechanisms which would appear to have been in the interests of the investor were circumvented because of industry opposition to them.

2. The Objectives of Regulation

Regardless of the rationale for regulation (and its legitimacy or logic), if it is centred on the correction of market imperfections, on paternalistic grounds, on ideological grounds or on political grounds, the defining of clear and straightforward regulatory objectives is a critical prerequisite to the construction of rules and institutional mechanisms by which those objectives can be achieved. If the objectives of regulation are to protect the retail investor from fraud, bad-advice or financial loss then, in theory at least, rules can be formulated and institutional structures conceived to achieve these objectives. Regulation can thus be a means of influencing "...decision-makers in the economy in the pursuit of *specified objectives* [the author's italics]."[373]

A Paternalistic Smokescreen

As noted already the objectives of the FSA were couched around the protection of the ordinary investor, Aunt Agatha. In the words of SIB press officer Betty Powell in 1988, she could "...go to someone who is honest, competent and solvent and...get a much higher level of service"[374]. John Major went even further, stating in 1986 that "The Financial Services Bill will safeguard people against unscrupulous overselling of personal pensions."[375] The Act and the rhetoric which accompanied it gave apparently cast-iron guarantees on the quality of advice that the ordinary investor would receive. Although the tone of the Government was profoundly paternalistic – couching things in terms of ignorant investors – investors were at least given the assurance that they could sleep soundly in their beds in the knowledge that a huge

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[372] There is also evidence, in the case of the PIA, that media and Government pressure encouraged self-defensive behaviour by the senior regulatory staff. The self-defensive behaviour of the PIA is considered later.
[373] Bannock et al, *op cit.* p.13.
[374] Betty Powell, *op. cit.*
[375] John Major, Under Secretary of State, 1986.

regulatory edifice and an army of regulators was in place to protect them. The regime even promised that investors would receive best advice – it is difficult to imagine what more investors could want?

A Lack of Clarity

Despite the promise of absolute protection, there was, on close analysis, no real definition of exactly what the objectives of regulation were. Moreover, the vague definition that *did* exist of the objectives of regulation seemed to run contrary to the supposedly over-arching objective of investor protection.

At no stage during the six years between the initial commissioning of Professor Gower and 'A-Day' were clear goals with testable aims and objectives articulated. As the industry veteran Gary Heath stated

> ...The problem we've got with them [the regulators] – and this has been a problem since day one – is that they refuse to define what they're trying to do in the first place. There is no definition of regulation.

The consumerist Harriet Hall[376] expressed similar concerns

> Well, I was looking at that [the objectives of regulation] from the point of view of the Financial Services Authority, because I thought, what does it say in the Financial Services Act? And it didn't say anything about what that should be. And all it seemed to do was to set up this elaborate structure of self-regulation without setting out what the goals of the self-regulation were in any particular detail.

In the first part of his report[377], Professor Gower had argued for regulation to be centred on the goal of investor protection. He stated that regulation should "not be greater than is needed adequately to protect investors...[but that it should not] seek to achieve the impossible task of protecting fools from their own folly. All it should do is to try and prevent people being made fools of."[378] Whilst this is a useful mission statement, it is hardly the basis for designing and running a regulatory regime.

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[376] Harriet Hall, The National Consumer Council, interview 11th February 1998.

[377] He went on to reiterate it in his later reports.

[378] Gower, L. (1984) Review of Investor Protection: Report Part I. (London: HMSO, Cmnd. 9125), p.6.

The White Paper published in 1985 was little better. In addressing the insurance industry, the consumer lobby and the City[379], it promised different and often conflicting objectives to different people. To the ordinary investors, consumerists, the media and policy makers it promised protection for the ordinary investor (Aunt Agatha). To the professional City markets it promised to secure the long-term success of London by stimulating competition and ensuring market efficiency. Finally, to the retail investment industry it promised self-regulation, a role for caveat emptor and conceded that competition is not necessarily always coterminous with the interests of the investor: which implies some restraints on competition were desirable.

When the Bill finally entered Parliament, the objectives of regulation became even more confused, as every conceivable interest jockeyed for influence. The first SIB Chairman, Kenneth Berrill argued in 1985 for regulation of "...a kind which suits the London market"[380] He further stated

> The job really is to help London to continue to expand as the major financial centre in our time zone in the period ahead, when competition for international business gets stronger by the month.[381]

This mercantilist perspective contrasts markedly with the views expressed by Gower, and also with the gloss given to the Act by the Government who placed the protection of the ordinary investor as the focus of attention: the protection of Aunt Agatha.

A Public Choice Explanation

The failure to articulate clear objectives for regulation until well into the 1990s is incomprehensible from a public interest theory point of view. It is a matter of simple common sense that in order to correct the detrimental effects of market failures, it is necessary to identify *what* they are and *how* they are to be corrected. At no stage was this done. Indeed the economics of regulation were at no stage even considered by Gower - or it would seem by policy-makers since. SIB, for example, was not even required to consider the costs and benefits of its rules until changes were introduced to regulation by the Companies Act of 1989. Even after this change, and despite the

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379 'City' meaning the professional markets of the City of London.
380 Referred to in the Financial Times, 7th March, (1985), Barry Riley.
381 Referred to in the Financial Times, 6th March, (1985), Barry Riley.

statutory requirement to consider the economics of its proposals, the SIB did not have a cost-benefit analysis department until early 1995.

By contrast, the absence of clear objectives makes perfect sense from the public choice perspective. From the public choice perspective there are at least three reasons for the lack of any clear definition of the regulatory raison d'être.

The first is practical. The origins of the FSA regime made it almost inevitable that the objectives of regulation would be nebulous. The regime emerged out of a protracted process of horse-trading between the Government and industry interests; the process of compromise, and the conflicting nature of the interests which the government was endeavouring to serve inevitably meant that no single, narrowly defined objective was possible. The Government wanted a regime which was – or at least appeared to be - unavowedly consumer protection oriented: the City demanded a regime to enhance the competitive position of the London markets and the life industry called for measures to limit destructive competitive pressures within the investment industry that were created by deregulation in the mid-1980s. The White Paper, which set the tone for the FSA itself thus set forth a multiplicity of objectives but with the over-riding gloss of 'investor protection'. Yet, a definition of exactly what investor protection meant was conspicuously lacking.

Secondly, there are good reasons why it is in the interests of the regulators and the government to retain a measure of confusion over the objectives of regulation.

- Confusion over the objectives of regulation gave the regulators a great deal of discretion as to both the specific goals they chose to pursue and also how they pursued them.

- Equally, the failure to define clear objectives for regulation evaporates any notion of being able to determine the success or failure of the regulators. The absence of clear statements of objective and the utilization of nebulous and ill-stated aims makes it impossible for any objective test of performance; financial scandals can be brushed aside as being somehow inevitable, impossible to prevent and somehow outside the goals of regulation anyway.

Gary Heath[382] expressed this in the following way,

> There's no definition of regulation because they don't want any – there's a vested interest that doesn't want a definition – and the vested interest is the regulators and the government. The regulators don't want it because if they had it we would be able to define their empire. If we knew who they were trying to protect against what, we would then say, well to achieve that you would need 200 people, 100 people, 50 people, a secretary and a dog or whatever you think is required. But they refuse to define it... [Also] [T]he regulators don't want it defined because if we did we'd be able to determine whether they were good or bad regulators.

Equally, there are good reasons to believe that the Government also had an incentive in failing to define clear objectives for regulation[383].

- There is a motive born out of expediency. By failing to articulate clear objectives, the Government was able to take the credit when things went right and to take cover when things went wrong.

- Also, if clear objectives for regulation had been defined – perhaps along Professor Gower's notion of preventing people from being made fools of but not protecting fools from their folly - then this would clearly have meant that some investors would have not been entitled to restitution; they would have been defined as fools. But, as Gary Heath argued "...just because they are stupid doesn't mean they aren't going to go to the press and make a fuss."[384]

What emerged therefore was a regime which, though promising cast-iron protection to the ordinary investor, in fact never, at least initially, defined exactly what Aunt Agatha was being protected from.

3. The FSA Institutional Structure

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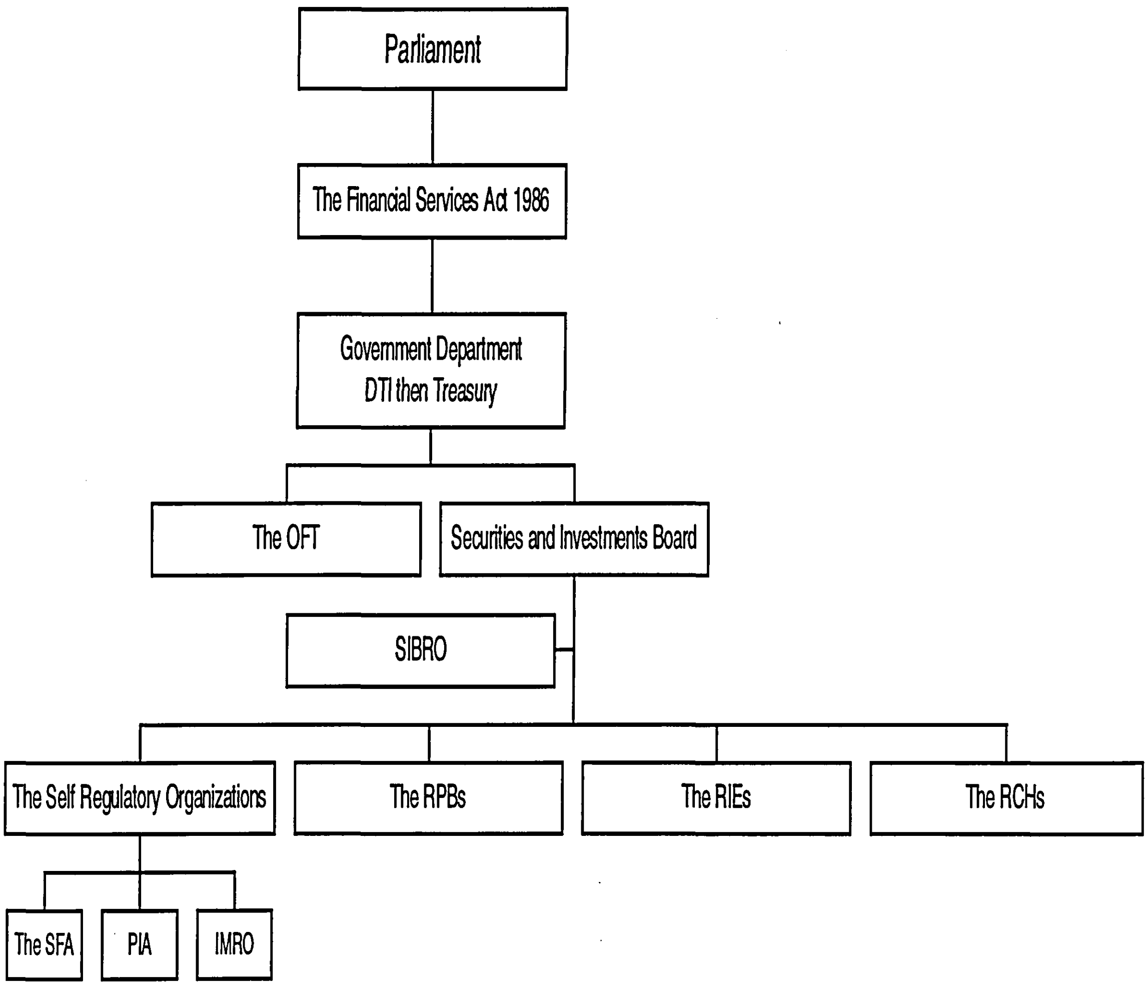
[382] Gary Heath, CEO of the IFA Association, interview 24th November 1997.
[383] See in particular Naomi Caine, "PIA – Pretty Inept Authority", *The Director*, July 1994.
[384] Gary Heath, CEO of the IFA Association, interview 24th November 1997.

The Act set up a system to regulate financial investments based on the organizing principle of 'self-regulation within a statutory framework': the industry would be regulated by a number of non-governmental regulatory organizations, each of which had its own devolved regulatory powers and responsibilities, and all operating under the statutory framework established by the Act.

Figure 5. The Institutional Structure Established by the FSA.



Despite the apparent grandeur of the part-statutory institutional structure put in place to protect Aunt Agatha, the statutory element of the structure was in practice more a façade than real. Despite the fact that there *was* a quasi-statutory body at the head of the regime, in practice it was the self-regulatory organizations that formed the lynch-pin of the regime. SIB had no effective sanctions against the SROs and of course they were fully aware of this fact. The success of the regime in enforcing the rules was thus dependent, almost entirely on the effectiveness of the SROs. In the case of protecting Aunt Agatha, the importance of the SROs meant that the roles of LAUTRO and FIMBRA were paramount. Unfortunately, both of these 'regulators' were trade associations and therefore had other priorities.

The institutional structure established by the Act was flawed in a number of ways: (i) related to the founding principle of self-regulation; (ii) related to the functional organization of regulation; (iii) related to the two SROs; (iv) related to the powers and effectiveness of SIB; (v) related to the SIBRO loophole; and (vi) related to the plethora of ombudsman schemes that were created. These flaws are now considered.

Self-Regulation

The industry demanded that the institutional structure be self-regulatory. The preceding chapter chartered the bitter conflict fought in Parliament in 1985-86 by the Government and by the industry against the opposition parties, elements of the media and consumerists for the retention of self-regulation as a founding principle of the FSA. The result was a regime, that although marketed as being 'self regulation in a *statutory framework*', was in fact predominantly run by the industry. The self-regulatory organizations, which were vested with the task of formulating rules, enforcing the rules and dealing with miscreant firms were trade associations. Practitioners were thus given the task of regulating themselves, despite the substantial evidence that in the period before the collapse of the industry cartels in the early 1980s the industry had palpably failed to consider the interests of the ordinary investor when they were fixing commissions and cartelizing the market.

Unlike self-regulation within a free market, where market disciplines exerted by free competition prevent anti-competitive practices,[385] the FSA established a regime in which practitioners were given considerable powers to manipulate the market and to impair competition. The SROs were given considerable powers to:

- Determine who should be allowed to conduct investment business: they were given the power to restrict entry.

[385] At least in the long run.

- Decide on how those authorized to operate should conduct their business: the power to determine best-practice.

- Implement control mechanisms to secure the protection of investors – including restraints on competition where it was destructive.

- To levy fines and close firms down who transgressed.

Practitioners were thus endowed with considerable state coercive powers, which although granted nominally for the purpose of protecting the investor, could easily be used to distort competition by limiting entry, by imposing restrictive practices and by forcing firms out of business. The two principal (theoretical) barriers to this kind of abuse of the system were (i) SIB in its supervisory role and, (ii) the OFT, which was supposed to vet all proposed rules for harmful competition effects. However, as will be shown, neither of these constraints proved to be an effective barrier to anti-competitive rules, practices and policies. SIB's supervision of the SROs was palpably ineffective and the OFT was over-ruled by Government when ever its advice was considered inopportune.

The Functional Structure

Self-regulation was to be undertaken by 'self-regulatory associations' dominated by practitioners. The self-regulatory associations were to be organized along the lines of the pre-existing industry trade associations. The organizational structure was thus organized along functional rather than institutional lines even though the traditional functional divisions within the industry were breaking down as more and more firms became conglomerates. Gower was clear in his wish to see regulation being organized along institutional lines but conceded that the highly tribalistic industry would not accept this structure.

There were three direct consequences of this functional structure:

- The task of regulation was made much more difficult because it meant that many firms had to be regulated by more than one regulator.

- The structure created a potential for regulatory arbitrage because the concept of the 'lead regulator', which was introduced to remedy the problems created by the functional structure, allowed firms to choose which of the SROs would undertake primary regulatory responsibility.

- The functional structure fuelled arguments from certain sectors of the industry for direct regulation by SIB (rather than being regulated by an SRO). SIB had never been envisaged as a front-line regulator and the consequences of the significant number of financial conglomerates who chose to be regulated by SIB are considered presently.

This functional structure brought with it a plethora of difficulties as far investor protection was concerned, and it made the task of regulating the industry infinitely more difficult.

The Securities and Investment Board

The industry was adamant in its opposition to the calls for an 'SEC for London'. It preferred that the supernumerary body should be a private commission, rather than a government department[386]. Thus, at the head of the regime[387] was the Securities and Investment Board. This was a private body, staffed by a range of professions including lawyers, practitioners, civil servants and economists, and was endowed with the task of implementing and enforcing the provisions of the Act. The primary mechanism through which the Act was implemented was through the SIB rule book (its Conduct of Business Rules) which received approval from the Government in February 1987. The SIB itself received formal approval to be the designated agency in May 1987.

Despite numerous changes at SIB since 1988 - including three Chairmen coming and going and two 're-launches'[388] - SIB remained largely ineffective as a supernumerary body. Its ineffectiveness was due to two main factors.

First, the SIB lacked any effective powers against either the SROs, which it was notionally supposed to be supervising or against the firms it regulated under its

[386] Gower, L. (1988), *op. cit.*
[387] Having been endowed with delegated powers from the Secretary of State for Trade and Industry.
[388] The New Settlement in 1989 and the Large Reforms from 1993.

SIBRO guise. It could not fine the SIBRO member firms. Nor could it exercise any practically effective controls over the SROs; it had only the nuclear deterrent of de-recognition which in practice it was clearly never going to use.[389] The SROs were aware of SIB's impotence and in practice operated with a very high degree of autonomy. An inevitable consequence of this lack of effective powers was that SIB was never a strong body.

Second, the staffing of SIB meant that it was unlikely to ever be the consumer's champion. The initial SIB Chairman was Kenneth Berrill. Berrill was a former senior civil servant in the Treasury having earlier been a lecturer in economics at Cambridge. At the time of being invited to Chair the SIB board, he was Chairman of the stock-broking firm Vickers da Costa and also a lay member of the Lloyd's Council. He was appointed on a salary of £110,000, considerably more than either the governor of the Bank of England[390] or the head of the home civil service[391]. Below Berrill as deputy chairman was Martin Jacomb. Jacomb had been one of Nigel Lawson's old friends from the Financial Times[392] and was Lawson's choice to be chairman. However Jacomb was too busy for the job and so took on the part-time role as deputy chairman. Jacomb was heavily connected with the industry having held the position as Executive Chairman of the investment banking group BZW which he joined on 1st of July 1985 having previously held a senior position at Kleinwort Benson.[393] In September 1986 Mark Weinberg, was appointed to join Jacomb as deputy chairman of SIB. Weinberg had been most influential in the formation of the rules which were to govern the regulation of the selling of investment products to the public. He was also the man who had established three of the successful 'new model' insurance companies including Allied Dunbar[394]. Weinberg's appointment to the MIBOC board caused amazement in the press. The amazement in the press was caused by both Weinberg's very strong industry background, but mainly because of the ethically questionable sales-practices of the Weinberg companies. In addition to

389 Even Sir Kit Jebens, then head of LAUTRO admitted as much, stating that "SIB never, in LAUTRO's time, developed a truly effective supervisory mechanism". (Jebens, 1996, p.15).
390 Robin Leigh-Pemberton earned £85,096.
391 Sir Robert Armstrong earned £63, 125.
392 Jacomb was the Financial Times' tax correspondent when Lawson was Features Editor.
393 Sir Martin Jacomb (knighted in 1985), was educated at Eton and then Oxford. He then became a barrister (1955-1968) before joining Kleinwort Benson in 1965. Jacomb also held senior positions at Barclays Bank (he was deputy Chairman between 1985 – 1993), BZW (Chairman between 1986 – 1991) and has been Chairman of the Prudential since 1995 and a director since 1994.
394 Known in the trade as Allied Crowbar because of its aggressive selling practices.

his position on the SIB board, Weinberg was permitted to continue running his insurance empire for three days a week.

The industry dominance of the SIB is illustrated by the makeup of its board. The SIB Board in place when the FSA became live in 1988 was in reality a congeries of the boards of two separate bodies, MIBOC and SIB. MIBOC, the body which Weinberg had chaired, was in reality little more than a trade association for the life offices.[395] Members of MIBOC, including Weinberg and fellow industry big-wig Marshall Field[396] joined the SIB in August 1986 when the two bodies were merged. Weinberg and Field joined such industry notables as Brian Williamson (Chairman of LIFFE and managing director of the Discount House, Fo Gerrard and National), Gary Runciman (Chairman of Walter Runciman, the shipping and insurance broking company), Dickie Alexander (Chairman of the British Insurers Brokers Association) and William Proudfoot (Chief General Manager of Scottish Amicable). In total, of the 16 Board member of SIB, only five were *not* industry people. Only one of those, Rachel Waterhouse of the Consumers' Association, was someone who might reasonably be called a consumerist. The other 'non-industry' people included John Clement, Chief Executive of Unigate the Dairy Foods Group ansd John Kerridge, Chief Executive of Fisons.

In 1989 David Walker was chosen to succeed Kenneth Berrill as SIB Chairman. Walker was an ex-Bank of England man who had made his name running the Bank of England's industrial policy in the early 1980s[397]. Walker was to spearhead the New Settlement reforms from 1989. The New Settlement was marketed as being an effort to simplify the regime. In fact, although Walker introduced some important simplifying changes, he also introduced more layers of rules. He implemented a new framework of core rules, principles and guidance. Ten principles (implemented in April 1990) and forty core conduct of business rules (implemented in

[395] MIBOC was set up because the life offices were desperate to avoid having the same rules applied to them as would be applied to professional markets, securities dealers and so forth. It was packed with life office representatives and was instrumental in formulating such principles as polarization and the rules on disclosure. Not surprisingly, MIBOC was known to industry insiders as Mark's Invention for Bollocking Other People's Companies.
[396] Field was chief general manager of Phoenix Assurance and former chairman of the Life Offices Association.
[397] Walker held senior positions at the Treasury from 1961 – 1977, then held the position of Chief Adviser at the Bank of England. He was also Chairman of the failed bankers, Johnson Matthey from 1985-1988.

1991) were instituted along with a third tier of more detailed and specific guidance rules and codes of conduct.

Walker also steered through a relaxation in the investor protection duties of the SROs, largely in response to industry lobbying. He reduced the duty on the SROs from providing equivalent protection to the SIB rulebook to merely providing adequate protection. As Hall states of the New Settlement Reforms,

> ...although there may be a case for simplifying the rulebooks of the SIB and the 'Self Regulatory Organisations', evidence has already emerged that this might herald a softening of the principles enshrined in the regulation of investment business, as approved by Parliament in the shape of the FSA. The principle of 'best advice', for example, is believed by some (for example, the Consumers Association) to have been toned down to the principle of 'good advice' in some areas...and, in the case of the rulebook of the Fimbra (published in 1988), to have become best advice to members on how to avoid being sued by investors!...It may be that rearguard industry pressure, operating under the cloak of demands for more flexibility to enhance international competitiveness, is subtly changing the shape of regulation to the investors' detriment.[398]

The New Settlement reforms also gave SIB power to state essential or central requirements, on a unified basis, leaving it to the other regulatory bodies to create for themselves the supporting detail which they might find desirable. However, this decision gave considerable discretion to the SROs to manage themselves. In addition, the legal right of the professional investor to sue for any breach of the regulatory framework enshrined in section 62 of the act was repealed.

In 1992, Walker (having been knighted for his efforts in 1991) was replaced with Andrew Large as SIB Chairman.[399] Large was commissioned in 1993 to conduct a review of the Two Tier System of regulation in light of its apparent failure in the Maxwell Pensions scandal. Large was hardly the most impartial of people to write such a report, being as he was the new SIB chairman, and it was little surprise that he

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[398] Hall, M. (1991), "Financial Regulation in the UK: Deregulation or Reregulation?", in Green, C. and Llewellyn, D. (1991), *Surveys in Monetary Economics: Vol. 2. Financial Markets and Institutions*, (Oxford: Basil Blackwell), p169.

[399] After leaving SIB Walker became Deputy Chairman of Lloyds Bank (1992-1994) and then tool up a position as Executive Chairman of Morgan Stanley (since 1994). Large, educated at Winchester, Cambridge, and INSEAD was an industry figure having previously been a director of Orion Bank (1971-1979), Swiss Bank Corp. (1980-1989), Phoenix Securities (1990-1992), London Fox (1991-1992), Chairman of the Securities Association (1987-1987), member of the Council of the Stock

was far less critical than might have been expected from a more impartial judge. Nonetheless, Large did steer through some important changes to rules on disclosure and on training and competence and was later rewarded by being Knighted in 1995.

The rank and file staffing of SIB consisted predominantly of lawyers, civil servants and (mostly) practitioners. At any point, as many as 40% of SIB staff were practitioners seconded from the industry. Although there was a plausible rationale for this policy of secondment - namely that it was necessary to have practitioners involved in the regulation of practitioners - the policy also had its dangers, specifically it encouraged SIB to be more sympathetic to the industry than it should have been as the supposed consumer's champion.

Given the weakness of SIB it is perhaps not surprising that it became viewed by many as being bureaucratic[400], uncommunicative[401], academic, difficult to work with[402] and not-'streetwise'[403]

The SIBRO Loophole

A fundamental flaw in the institutional structure established to regulate investment business stemmed from a loophole within the Act itself. In order for the system to be genuinely self-regulatory it was argued by sections of the industry (principally the banks and building societies) that there should be an alternative to regulation by the relevant SRO. The regulators and politicians thus contrived to allow investment firms

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Exchange (1986-1987), member of the Panel on Takeovers and Mergers (1987-1988), of the Lloyds Council (1992-1993) and of the Board of Banking Supervision (1996-1997).

400 Andy Purvis, compliance manager at Sun Life commented "The SIB was sort of much more remote from us. Yes, they send out consultative papers, yes we consult on them, yes we take the opportunity to give our comments back. I think it would be nice to see a lot more feedback coming back from all of these consultative exercise. I mean you tend to give your comments and if you're lucky you get an acknowledgement, then it goes into a big black hole, and often you know that they're already made up their minds and its consultation just for the sake of consultation – just to be seen to be doing the right thing."

401 Michael Abrahams, of Barclay's Life, stated "SIB were notoriously uncommunicative. Before I came here, I joined Barclays in March 1995, before that in 1993 and 1994 the SIB staff had said to the previous compliance people when they asked for advice that 'it's your job to know what to do, it's our job to make sure you're doing it – It's not our job to give you advice!'... SIB were unreceptive, unapproachable, unhelpful, famously deaf and famously daft! So they weren't helpful."

402 Even Mark Boleat admitted that "SIB was in the hands of lunatics... What went wrong with the FSA was mainly the people who were involved in running it initially, Kenneth Berrill as Chairman, Kate Mortimer one or two other. We found them – I was running the Building Societies Association – so difficult that we complained to the Bank of England about them and Eddie George, who was deputy Governor, or may not even have been deputy governor said "It's no good complaining to me, I have the same problems with these people".

403 Gary Heath commented "...SIBs very theoretical and academic, it isn't street-wise at all. And it also thinks it has unlimited powers..."

to be directly regulated by SIB (or more properly SIBRO[404]). SIB was supposed to be the supernumerary body, responsible for overseeing the other regulators (the self regulatory bodies) who were responsible for the practical task of regulation. However, the SIBRO route gave SIB an additional responsibility for which it was poorly equipped to undertake. SIB was not supposed to be a front-line regulator and even lacked the powers to fine its directly-regulated firms. As Lord Runciman, Deputy chairman of SIB, said in a speech on 19 Nov 1996, one of the flaws of the FSA was that SIB "...had no power to fine, unlike the junior regulators that reported to it."

It is therefore perhaps not surprising that the regime operated by SIBRO appears to have been rather more lax than that operated by the other regulators. The Deputy CEO of NPI, Laurie Edmans[405] stated "...I think, if you look at the pensions mis-selling business, they were appallingly lax. You only have to ask any SIBRO authorized company when they had their first SIBRO inspection visit and do a cross check of the answer to that question with the biggest sinners in the pensions mis-selling. Note the correlation and draw your own conclusions!" Gary Heath[406] was even more explicit in his description of the SIBRO regime, claiming that it was

> like happy valley! [Firms] couldn't be fined, the only real power that they had was to be suspended – well it's pretty unlikely that the Prudential is going to be suspended by SIB! Or anyone else come to that. So really their only powers were ones that were of no use to them. And the quantity and quality of regulation was minimal, I mean to give you an idea – A friend of mine was on the Missions committee at PIA, and she was saying that the average IFA has a file four or five inches thick, and people coming over from SIB have about 10 sheets! That's the sum total of the regulation done!

In his report in 1993, Andrew Large noted the soft-touch at SIBRO[407] and recognized that some firms chose to be regulated by the SIB for this reason. In a similar vein, Michael Abrahams[408] commented,

> Well most people were happy to be regulated by an SRO – if only because there was the practitioner input, and things might be a little saner. A few people decided to be regulated

[404] The Securities and Investment Board Regulatory Organization.
[405] Laurie Edmans, Deputy CEO, NPI, Interview 27th February 1998.
[406] Gary Heath, CEO of the IFA Association, interview 24th November 1997.
[407] Large, A. *op. cit.*
[408] Michael Abrahams, Compliance Director of Barclays Life, interview 26th January 1998.

by SIB on the basis that they couldn't fine and maybe that they didn't understand the issues too well.

The existence of the SIBRO option introduced yet another opportunity for regulatory arbitrage. There was a perception (at least) that firms were choosing with whom to be authorized on the basis of the laxity of the regime.

LAUTRO and FIMBRA

Two 'regulators', LAUTRO and FIMBRA were delegated with very broad regulatory responsibilities[409] to regulate retail investment business. Both of these regulators (and especially FIMBRA) probably had an impossible task. For if they are to be judged against the cast-iron promises made of regulation, then it is almost inconceivable that even the most diligent, efficient and omnipotent of regulators could have transformed the industry which was [supposedly] teaming with corruption and sharp-practice, into the relative haven of virtue, integrity and honour that was promised.

However, there is a considerable difference between being set an impossible 'public interest' task and failing to achieve it, and choosing to pursue a different task altogether, and moreover one diametrically at odds with the official task. Both FIMBRA and LAUTRO failed to deliver the promised levels of investor protection. They also exhibited behaviour more becoming of trade associations than regulators. But this should not be surprising, for they were established along the trade association model.

LAUTRO and FIMBRA were also perceived as such by many in the industry. In the absence of any effective controls on their activities by SIB, they 'regulated' in the interests of their members, not in the interests of the investor. They failed to enforce the rules, they resisted the imposition of rules that were in the interests of the investor and they operated without any consumer input to policy making. In short, the SROs were trade associations for their members. As Kelvyn Baynton[410], a PIA director confessed in 1996 "LAUTRO and FIMBRA were widely perceived to be trade associations – but they had to be..." Phil Telford[411], senior researcher with the Consumers' Association expressed similar views "I think that FIMBRA particularly

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[409] And were endowed with wide-ranging regulatory powers in order to carry out these responsibilities.

[410] Kelvyn Baynton, Public Affairs Director, the PIA, interview 14th August 1997.

was very much perceived as, and I think pretty largely was a trade body for independents [IFAs] and LAUTRO quite similar for the insurance companies." In fact both of the regulators had their roots as trade associations.

FIMBRA

The task of regulating the FIMBRA[412] constituency was always going to be very difficult due both to the sheer numbers of firms that FIMBRA had to regulate, their geographical dispersion and the fact that it was the FIMBRA members where the level of competence was generally lowest and also probably where most of the bad practices emanated. These small member firms did not have the resources of a Prudential or Midland Bank, consequently, FIMBRA was (and was always going to be) extremely vulnerable to financial crises brought about by compensation claims and so forth. The combined effects of substantial compensation claims and the haemorrhage of members that FIMBRA suffered since A-Day meant that FIMBRA had the greatest possible incentive to try and retain the members that it did have. Michael Abrahams, ex director of LAUTRO argued,

> Yes, they didn't come in and say clearly 'we are a trade body' but their approach was primarily 'all our subscriptions are paid for by our members, our members hate regulation, and if we clomp around too much they'll all leave - and anyway they can't really afford it, [because] they're only little firms, different to these big life companies you know. So we've got to be a good regulator, but we mustn't swing our arms around too much and cut too many heads off because we rely on these people to pay the bills for regulation.' And it did rather get in the way, if you look back at the history of FIMBRA, they fined many, many people for failing to send in their annual reports – there reports and accounts – on time, and to provide various other bits of information. I think, from memory, that the only prosecution that they ever had for bad advice was the Levitt case and that, and it is only my view but it could be justified, that is not a reflection of the quality of advice that you will find out there in IFA land. They just didn't want to get to grips with that.

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[411] Phil Telford, Senior Researcher with the Consumers' Association, interview 11th February 1997.
[412] FIMBRA had its origins in the trade association the Association of Licensed Dealers in Securities (ALDS) which was founded in 1979. In 1982 the ALDS changed its name to the National Association of Security Dealers and Investment Managers (NASDIM). In 1983 NASDIM was recognized as an approved association of dealers under the Prevention of Fraud (Investments) Act 1958. In 1986, in anticipation of the FSA, NASDIM changed its name to FIMBRA.

IFAs were found to be moving from FIMBRA authorization to IB(R)A authorization (the Insurance Brokers Registration Council being an RPB under the Act). Kenneth Clucas highlighted this problem in his report citing the fact that between A-Day and 1992, some 11% of the IFAs initially registered with FIMBRA had left FIMBRA to become regulated by the IBRC. In addition to the 11% moving to the IBRC, another 5% had moved to other regulators and a quarter had become tied. Clucas comments that many had left FIMBRA "...because of the existence of a softer option elsewhere."[413]

The combined effects of (i) FIMBRA's fees being paid by its members, (ii) a competition in laxity between FIMBRA and the IB(R)C, (iii) the domination of the FIMBRA board and staffing by practitioners, and (iv) the lack of effective channels of control by SIB over it, meant that it was always going to be profoundly sympathic to its members. The evidence (presented in the following chapter) of FIMBRA's ineffectiveness in delivering investor protection indicates that it predictably succumbed to these pressures.

LAUTRO

LAUTRO also had its origins rooted firmly in the industry. It was founded as a result of negotiations between Mr Barry Sherlock[414] and "...influential firms and people [in the industry] with a view to setting up an SRA for life assurance, unit trust firms and friendly societies".[415] It was formally incorporated as LAUTRO Ltd. on the 13th of August 1986 and had its first meeting at 11am on Tuesday the 24th of June 1986 at Aldermary House; significantly Aldermary House is the headquarters of the ABI, for it was the ABI, the trade association for the life offices, which was the organizing force behind the establishment of the regulator. The centrepiece of LAUTRO was the Maximum Commission Agreement which was a mechanism, demanded by the product providers in order to control distribution costs. As Gary Heath[416] stated

[413] Clucas, Sir Kenneth, (1992), Retail Regulation Review: Report of a study by Sir Kenneth Clucas on a new SRO for the Retail Sector, (London: SIB), p.16.
[414] Chief Executive of Equitable Life who was later to succeed Mr Marshall Field as Chairman of the Life Offices Association
[415] Jebens, K. (1986), *op. cit.*, p.11.
[416] Gary Heath, CEO of the IFA Association, interview 8th April 1998.

> the product providers realized that with LAUTRO they actually had a vehicle from which they could actually curtail some of their costs – and they had all sorts of things like the Maximum Commissions Agreement and so on...they weren't actually regulatory things, they were attempting to use regulation to achieve a commercial end.

LAUTRO (supported by the Mark Boleat led ABI) played a pivotal role in defending the interests of the product providers, indeed Kit Jebens, the LAUTRO Chairman expressed the LAUTRO raison d'être as being to "...promote the interests of commerce."[417]

Boleat, the ex-head of the Building Societies Association, played a key public role in promoting LAUTRO. The ineffectiveness of LAUTRO and FIMBRA in enforcing the rules will be considered in the following chapter. I show, in the following chapters, that both organizations acted as public choice would predict and served the interests of their members (from the industry) rather than the ordinary investor whom they were, at least on paper, supposed to serve.

Accountability

In the private sector there is the discipline of the market. In the public sector there is supposedly the discipline imposed by accountability. However, the theoretical lines of accountability built into the institutional structure were in practice lacking. SIB was nominally accountable to Parliament through the Secretary of State and the SROs were accountable to SIB. However, in practice control/ supervisory relationships are subject to considerable agency problems. These problems were made worse by the bureaucratic nature of SIB; the existence of an executive and non-executive hierarchy at SIB and its tall hierarchy simply adds to the complexity of the institutional structure and the nebulous nature of the relationship between SIB and the SROs. In practice therefore, the SROs acted with an alarming degree of autonomy.

A Plethora of Ombudsmen

In addition to the creation of the SROs, RPBs and RIEs, the FSA also established four ombudsman schemes for the resolution of investor complaints. There already existed two ombudsman schemes in operation by the time that Professor Gower began his review. These were the Pensions Ombudsman, which was set up in 1975, and the

Insurance Ombudsman, established in 1981. The four schemes established under the FSA were the Investment Referee, the Complaints Commissioner, the FIMBRA Arbitration Scheme and the SIB Arbitration Scheme. Each of the six ombudsman schemes had different rules, different underlying assumptions and varying amounts that could be awarded. Rather than simplifying the process of complaining, the changes introduced by the Act actually made things endlessly more complex. Kit Jebens commented "The biggest complaint we get is that for investors, the regulatory system is an absolute jungle, knowing who to complain to is, for the average investor, impenetrable."[418]

4. The Rules: Omissions

The preceding chapter argued that the industry was largely successful in determining which specific *control mechanisms* formed the bedrock of the FSA 'investor protection' regime: polarization, the maximum commissions agreement, best advice and the rules on the disclosure of information on charges and commissions were substantively determined by practitioners. A consequence was that the rules promulgated were fundamentally flawed from an investor's point of view. The rules were flawed in at least two respects.

- In an effort to avoid implementing certain rules, other rules were contrived which were not only less effective in terms of investor protection but, more seriously, had 'secondary' effects that were inimical to the interests of the investor. These harmful 'secondary' effects of regulation are considered in the following chapter.

- Industry pressure meant that areas which should have been high on the list of investor protection priorities were not addressed at all.

A most remarkable aspect, an important factor in the failure of the FSA regime and a prime example of the role of the industry in frustrating investor protection was not what was *included* in the Act or in the rule books of the SIB and SROs, but what was

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[417] Jebens, K. *op. cit.*, p.61.

excluded from the regime. In the early years, regulation failed to address, in any more than token form:[419] (i) standards of competency through formal requirements for training and individual registration; (ii) the problem of endemic bad advice through hard disclosure of commissions and charges, through addressing the systemic problem of the incentive structures within companies and through controls on such practices as 'cold-calling'; and finally (iii) the information asymmetry between buyer and seller of investment products. The failure of regulation to address these issues is baffling. Or at least it would be baffling if the public interest explanation for regulation was considered to be valid.

From a public interest perspective, if investor protection is the goal of regulation then low standards of competency, the opacity of products, commission bias and the low levels of sophistication of most investors *should* have been high on the 'hit list' of priorities for the policy-makers right from day one. However, from a public choice perspective it *is* possible to explain the failure of regulation to address these key areas: it was not in the interests of the industry to address these issues and neither the Government nor the regulators were prepared, at least initially, to take the industry on.

Failure to Address Standards of Competency

In the pre-FSA investment industry, standards of competency amongst people selling investment products to the general public were low by any standards. There were exceptions to this, for example insurance brokers had to sit quite rigorous exams before they could become registered under the Insurance Brokers (Registration) Act, and the professional investment advisers (now largely regulated by IMRO and SFA) were regulated by the stock exchange and the Chartered Insurance Institute where rigourous professional exams had existed from long before the time of the FSA. However, on the retail side (especially in the area to be regulated by FIMBRA), standards were undoubtedly low. From the 1960s, with the advent of the 'New Model' insurance companies created by Sir Mark Weinberg, the trend was one of

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418 The Independent, "The People's Friend is Drowning: Clare Dobie looks on the near hopeless task of setting up a regulator for personal investment", Clare Dobie, 26th August, 1992.

419 Not even in token form in some cases.

recruiting as many salesmen as possible[420], providing a few days of intensive training and then unleashing the highly incentivised commission-driven salesmen on the uneducated public[421]. Again, Laurie Edmans[422] noted:

> ...But there are things about the industry that I think you can trace their origins to Abbey and Allied Dunbar that were particularly damaging...I'd cite the practice of generating sales by recruiting as many commission-only salesmen as you can lay your hands on, cramming them all into a hopper, waiting for the 90% or more to fail – and then firing them in a callous kind of a way; but you end up with a 10% who will generate business. And on a commission only basis aren't all that necessarily fussed as to how they do it.

Michael Drakeford[423], a director of Midland bank recounted a tale which was repeated by a number of other practitioners in slightly altered form:

> ...there's an old story of a compliance officer at Barclays bank told me once. He got a complaint from a customer and the customer walked into the bank branch and said 'I'm really cross, I came to you a few weeks ago and I asked you to arrange for me to see one of your financial planning managers.' You said 'Yes', and you sent him along and he came along to me, 'He's an expert in the field you told me', bank manager says 'Yes, that's right', 'An expert in the field'. 'Well how was it that five weeks ago he was my window-cleaner!?' Well, absolutely true...

The Parliamentary Select Committee Report in 1993/ 94 made the following assertion:

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[420] Michael Abrahams, ex LAUTRO director commented "...I always call it the looking glass test up to about '88, you know hold a mirror up, get the person to breathe on it and if it steamed up he was in!"

[421] Steve French recounted "And you had got companies, like allegedly Liberty Life, who stood on street corners. I mean I was offered a job, I'd be about 18, I'd just started in the industry and a chap stopped me on a street corner, High Street, Sheffield, and he said 'Come and have a chat with us and we'll offer you a job!', walked straight up into the offices, I was offered a job of about £18,000, within about a year, they said I'd be on £25,000 (I mean, bearing in mind I was working for Sun Alliance on £3000 a year at the time), and I'd be a manager within a year to 18 months, at the optimum. And I mean the thing is, is that's there's no way that at that stage – I mean I'd never sold life assurance before, I was an underwriter on the general side – but they were offering sort of £18,000 this was back in 1981 or 1982 or something like that, and £25,000 in a year to 18 months time. Sounded great! I bottled it!"

[422] Laurie Edmans, Deputy CEO, NPI, Interview 27th February 1998.

[423] Michael Drakeford, Midland UK Compliance Manager, interview 19th February 1998.

> In this industry it is crucial that salesmen and advisers are adequately trained, and on an on-going basis, so as to be able to give and explain the 'best advice' that the Financial Services Act demand.[424]

Remarkably though, the requirement for a minimum demonstrable level of competency for salesmen and advisers was to wait until July 1997, nine years after A-Day. The reason for this delay was that parts of the industry (and especially some IFAs) had little incentive to indulge in the very costly business of training to the standards demanded by consumerists and other bodies such as the Life Insurance Association[425]. In some parts of the industry, training has traditionally been viewed as a cost of distribution, and the trend within the banks and life offices has tended to be based on short periods of training centred on learning about the company's products and learning how to sell them, not about identifying consumer need which is a prerequisite to giving best advice.

The industry's opposition to the introduction of training and competency requirements in the 1980s and early 1990s is openly admitted by some industry executives. Kit Jebens freely admitted "...within the original framework, one element was missing: training and competence."[426] But as Gary Heath[427] argued "...most assurance companies and banks have the same agenda – if they can get their Sharons and Tracys selling this stuff with almost next to no education, they're perfectly happy because they look at advice as a cost of distribution – the lower they can get their costs of distribution, the happier they are generally. So they actually don't really care about it..." and Karl Snowden[428] "Well I think, as far as I can see the three main hits of regulation (from an industry perspective) were training and competence, which is hugely beneficial. And it is no credit to the industry that it fought tooth and nail with barricades and sand-bags and everything...I've argued long and hard with bancassurers – their idea that if you're only selling mortgages you shouldn't have to be FPC qualified."

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424 Treasury and Civil Service Select Committee, *Retail Financial Services Regulation: Fourth Report,* (London: HMSO), page viii.

425 The LIA introduced proposals for a licensing and training regime twenty years before it was finally introduced.

426 Jebens, K., *op. cit.*, p.56.

427 Gary Heath, CEO of the IFA Association, interview 8th April 1998.

428 Karl Snowden, Public Affairs Director B.A.T. Financial Services and Allied Dunbar, interview 3rd March 1998.

By the latter years of the 1990s and into the 21st century, the standards of competency in all sectors, but especially in the old FIMBRA and Lautro constituencies[429] had clearly and manifestly improved on what had gone before. The FPC exam, whilst intially less rigorous than many other professional exams, in later years (and having been taken over by the Chartered Insurance Institute) became much tougher and the Advanced Level FPC[430] became the new standard to be achieved. In addition, many institutions (including the Halifax) used the tougher Institute of Bankers, financial advising exams. It is generally accepted that standards within the industry have dramatically improved due to the introduction of training and competency requirements.

A range of new exams were introduced and many different organizations competed in what had become a lucractive business for many professional bodies and training companies. The Chartered Institute of Bankers (CIOB) and British Bankers Association introduced and now run a wide range of different examinations for different subjects, the CIOB also operates under the name of the Institute of Financial Services and runs a further range of courses. Some investment advisers will also undertake corporate treasury exams (run by the Association of Corporate Treasures) and many of those offering advice in banks will take exams from the Chartered Institute of Marketing. Some advisers also take CIMA exams.

The central criticism is thus, not that exams were not introdued, but that it took too long for the regulators to introduce them. As Ken Davy, Chairman of DBS IFA Network said,

> But, all of us who, certainly had been involved in the Life Insurance Association initiative felt that to disregard competence as a key element of delivering the regulatory standards that we all want to see – and that's what it's about to make sure that Aunt Agatha does get the right advice – to ignore competency was a great mistake. It may have been that it was felt to be too big a task, it might have been felt that it would have taken too long. But it was simply ignored, it wasn't as if they said 'no, we're not going to have competency training for Z,Y,Z years because it's too big a job' It was just almost as if it had been over-looked.

[429] Traditionally, it was the FIMBRA constituency where the most serious problems in terms of low levels of competency were found. The professional advisers at IMRO and at the Recognised Exchanges tended to be subject to professional exams and were thus, in general, highly competent.
[430] A far more rigorous exam.

And as John Ellis remarked,

> I was having lunch with the Chairman of SIB, Sir Andrew Large, and I said, 'If we'd actually had those exams and had been testing people's knowledge [from much earlier] it at least would have stopped all these people saying "I didn't know!" [i.e. salesmen claiming ignorance], and he said 'You're right'. It's a pity they didn't do it but it's too late now.

If the tough FPC exam had been in place earlier, especially for those FIMBRA members, then it is likely that the mis-selling episodes would have been much less serious.

<u>The Failure to Introduce Hard Disclosure Requirements</u>

A further area that the regulators omitted to address *in the early days* was that of disclosure. The insurance companies did not want to have to disclose the high costs that were levied on their products for fear that it would cause a significant fall in demand. The policy makers supported them, arguing that people could not understand the information so they should be kept in the dark.[431] A consequence of the industry's opposition to hard disclosure was the invention of the concepts of polarization and the MCA, both of which had severely damaging effects on investor welfare and both of which endowed benefits on the industry. The disclosure saga is considered below and the harmful effects of polarization and the MCA are considered in the following chapter.

<u>The Failure to Tackle the Sales-Driven Culture</u>

The experience of training and competency is mirrored in the failure to tackle the problem of poor advice and mis-selling associated with the systemic sales-driven culture within firms. A glaring omission from the regime was the failure of the FSA to tackle the incentive structures in place within most banks, life offices and for IFAs. It is folly to lay down requirements for 'best advice' if the incentives and the culture within sales organizations is one of maximizing sales at all cost (especially if you don't have disclosure and consumer education to alert consumers to these incentives and biases). In fact this is exactly the description of most of the organizations selling investment products. Consumerist Phil Telford lamented

> And because of the way the bonus structures are driven, the goal is the next sale. I mean senior people in these companies will say it's all about building relationships, long term customer relationships, customer care, *it's better to keep one customer than to sell to three new ones.* But they don't do that! They don't believe that! They have very high initial commission structures for financial advisers and there own salesforces. It's all geared to new business sales. They don't go back and look three years down the line, you as a salesperson have 100% of your cases still on the books so here's some extra money.

Typically, the Board of Directors sets performance targets for the company - in terms of sales turnover. The National Sales Manager then allocates targets to the regional areas. The Area Sales Managers then allocate targets to branches; and branch managers allocate targets to individual salesmen within each branch. The performance of each salesman is then divided into monthly targets, and charts posted on office notice-boards illustrate how the salesman was performing in relation to their targets. According to James Hanlon, ex-Area Sales Manager of London Life, salesmen would be given a three month period in which to prove their selling ability. If they failed to meet their targets after this time they were fired.

It was almost universal practice within the investment industry to remunerate salesmen by commission (or a salary which was directly related to their sales performance). Awards were given for sales performance with the top few salesmen rewarded with foreign trips[432], flights on Concorde, Porsche 911s[433], and creates of champagne. Quarterly bonuses were also paid, and these were well publicized so that everyone knew how they were doing. Every quarter, company wide sales performance figures would be sent to the branch so that sales people could see how they were doing within the company. In addition there were embarrassing penalties for failure:

> Bizarre punishments were also devised for those who had done badly: at one branch of a big insurer, the man who was bottom of the sales league over the previous month would be told to walk around the building for a day dressed in ladies' underwear. A variation of

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[431] Weinberg *op. cit.*; Simpson *op. cit.*

[432] Including in the testament of one ex sales-manager a 'Far Eastern Sex Tour'.

[433] As Gary Heath recounted "[T]hey tried all sorts of things – golden handcuffs, golden handshakes, Porsche 911s and all sorts – certainly Porsches were an element – to try and get these guys sorted out."

this would be to make the person at the bottom of the pile wear an over-sized nappy all day.[434]

Everything within financial services companies was geared towards short term sales maximization. Regulation failed to address this systemic problem, merely implementing top-down commands without addressing the culture that was to combine with the information asymmetry problems to make mis-selling inevitable.

An integral feature of the sales-driven culture was the practice of cold-calling on members of the public at their homes to sell them investment products. The FSA also failed to combat this practice, which was severely criticized by Gower[435]. The practice of cold-calling was outlawed for everything except life assurance and unit trusts; the two areas where cold-calling was most ubiquitously practiced as a marketing tool. Yet again, the investment industry received privileges denied to other, weaker sectors.

The Failure to introduce Individual Registration

The final omission from the FSA regime was that of individual registration. Individual registration would have required life offices, banks and the like to register centrally each person engaged in the selling of investment products. The most important benefit of this would have been that crooked salesmen could not have left one company and immediately joined the staff of another (or even become an IFA). However, individual registration was opposed by the industry – principally on cost grounds – and so was not a feature of the initial regime put in place. Once again, the interests of the investor were compromised by the wishes of the industry.

5. The Disclosure Saga

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434 The Financial Times, 11 June 1994, "When he dies my dear, all this will be yours: How the life assurance industry, with such a strong position in society, became accused of a breach in trust" by Peter Marsh.

435 Gower, L. (1982; 1985), *op. cit.*

The initial SIB rule book fudged the issue of disclosure, opting instead for a regime centred on the Maximum Commission Agreement[436] and 'soft disclosure'. The official rationale for this was that as long as there was a cap on commissions it was not necessary for investors to know the exact details of commissions and charges. In fact, as was argued in the preceding chapter, commission fixing was an essential way in which the life offices were able to control their costs of distribution. The SIB was also complicit in arguing against hard disclosure. In 1986 it stated that "The risks of adopting disclosure requirements that conveyed an apparent, but spurious sense of accuracy, misleading sense of authority, and an unjustified sense of relevance seemed to the Board to outweigh any potential benefits."[437] It would continue to oppose the OFT and Consumerists until the Government finally moved in 1995 to introduce hard disclosure.

The Demise of the Maximum Commission Agreement

In 1988 the main focus of debate was with the MCA. This anti-competitive policy which was not only a pivotal element of the disclosure regime[438] but also a very important element of the FSA regime itself[439]. However, the MCA was to endure for little more than a year. On the 12th of August 1987 a SIB official visited the LAUTRO board to explain that the European Commission might require the full disclosure of commissions. However, at a further meeting between LAUTRO and the Under Secretary of State for Corporate and Consumer Affairs, Francis Maude, the Government made clear its continued support for the limited disclosure regime and the MCA. Although it was widely known that the OFT had grave reservations about the disclosure regime and considered that anything less than hard disclosure was unlikely to be coterminous with the public interest, the Government (the DTI) announced its intention to over-rule them.

In March 1988, a mere two months prior to 'A-Day', the OFT published its first report on LAUTRO's rule book. LAUTRO also received a letter from the Director General of Fair Trading stating that "...a MCA combined with soft

[436] Which was to be run by LAUTRO which had strong links with both the Life Offices Association and the Association of British Insurers, the trade associations for the life offices.
[437] SIB, (1986), "Life Assurance Companies – Disclosure of Expenses and Charges".
[438] The argument being that if there was an upper limit on commission levels established by a commission agreement there was no particular necessity to have hard disclosure which was the other apparently more obvious option.

disclosure would be considered illegal by the European Commission"[440]. Following this, Francis Maude, "...made it clear that the Government would not recognize LAUTRO's Rule Book unless the Commission consented to at least a period of exemption"[441]. The Government (the DTI), despite failing to win exemption for the LAUTRO's rules, won an eighteen month period over which a replacement for commission fixing would have to be found. This period would supposedly allow the industry to prepare for the new regime.

According to the OFT the MCA agreement was distorting competition to a "...significant extent".[442] The effect of the system was to encourage life offices to seek to increase their market share by recruiting tied agents *en masse* by offering them much higher levels of remuneration than was available to IFAs (under the MCA agreement). The tied sector thus expanded whilst the IFA sector (also hit by much greater average compliance costs) suffered a contraction – directly against the intentions of Gower who had argued that independent advice was critical.

<u>Disclosure Rules Post MCA</u>

After the collapse of the MCA, the SIB instituted new disclosure rules in August 1989. However, these new rules were conspicuously lacking any mention of the hard disclosure which consumerists and the OFT had called for. Indeed, SIB's original proposals for reform published in 1988 had been far stronger than what it ultimately implemented. The earlier proposals had called for charges and expenses to be expressed in cash terms and at the point of sale. The climb-down by SIB aroused accusations that it had been nobbled by the industry, as was reported in the Press[443]. Nonetheless five changes were instituted in 1989:

- Changes were made to force tied agents to include clear statements in advertising that they only gave advice on the products of one firm, and that the adviser was an appointed representative.

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[439] Indeed LAUTRO made the setting up and running of the MCA its *grande project.*
[440] Jebens, K., *op. cit.*, p.23.
[441] Ibid.
[442] The Office of Fair Trading, (April 1990), The Disclosure of Information about Life Assurance Products and Commissions Paid to Independent Financial Advisers, p.11.

- A requirement was introduced whereby all firms, both tied and independent must give to the investor, at the start of the selling process, a concise 'buyers guide'. The 'buyers guide' was designed to outline the status of the adviser and tell the investor what information should be provided to them by the adviser.

- At the point of sale, IFAs must tell the investor the method by which they are remunerated and provide details of the extent of the remuneration after the point of sale and as a percentage of the premiums. These details of commission levels must be sent within fifteen days of the sale along with a cancellation notice.

- Advisers were required to supply both the extent of actual charges on unit linked policies and the effect of charges. The effect of commissions was to be shown in the form of a percentage reduction of the projected investment yield on certain standardized assumptions (the so called Reduction in Yield). This information had to be given in product particulars within fifteen days of the sale.

- For with-profits policies there is a potential difficulty identifying the expenses relating to an individual policy.[444] For this reason the life office was required to "...state the expense assumptions which have been used in the process of establishing the company's premium levels".[445] An indication of the expenses would then be disclosed within fifteen days, shown as an estimated percentage reduction in yield.

More Papers but No Action from SIB

Despite the changes instituted in 1989, the commission disclosure issue remained the *cause celebre* of continuing debates on the FSA regime. The OFT remained implacable in its insistence that hard disclosure should be instituted. The pressure

[443] See for instance, The Independent, 27th May 1989, Lorna Bourke "SIB's climbdown on disclosure has watchdogs angry".
[444] This is because the contributions of all policy-holders are aggregated into a central fund, along with profits and income from the fund.

culminated in two papers being published by SIB. The first was in December 1988 titled "Life Assurance and Unit Trust Disclosure: The Regime for 1990". The second was published in May 1989 and was titled "Life Assurance and Unit Trust Disclosure". Between them, these papers made four key proposals.

First, that at the outset advisers would be required to declare their status as being either tied or independent. This would be through the issuance of a 'buyers guide'. Second, that at point of sale there would be disclosure of specimen data on the effects of charges in the form of reduction in yield. The reduction in yield data would illustrate the percentage by which investment return would be reduced to pay the life offices' costs. Third, after taking the decision to buy, the investor would be furnished with a product particulars document which would provide "...sufficient information and assistance to enable him to satisfy himself that he has made the right decision and was properly advised."[446] For IFAs the disclosure of commissions would also be required at this point and would be sent from the product provider directly to the consumer no later than at the issuance of the cancellation notice. Finally, SIB suggested that for with-profits policies, an extra 'with-profits guide' should be provided on demand.

There are two key elements to the disclosure of information on commissions and charges and debate ensued on all of these areas.

- Illustrations: These provide an indication of the prospective future benefits on investment products. Future benefits are dependent on time to maturity, the value of premiums paid, the assumed rate of investment growth and finally the charges.

- Surrender values: These were determined by the life offices. In formulating surrender values, the life offices had traditionally taken the view that as investment policies were designed as long term investments, it was in the investors' interests if the charges were levied in the first few years of the policy's life. In consequence of this 'front end loading' of charges and commissions, the surrender values for policies in the early

[445] OFT, (1990), *op cit.*, p.20.
[446] Jebens, Sir Kit, *op. cit.*, p.42.

years tended to be miserly; not surprisingly the life offices were reticent to disclose this fact.

An integral part of the debate over disclosure was on the issue of whether own-company charges or standardized charges should be used in the production of disclosure data. The life offices wanted standard charges whilst the IFAs, OFT and consumerists demanded that own-company charges should be used. The SIB, supported by LAUTRO, ultimately and predictably took the life offices' view and argued for the continued use of the meaningless standard charges in its Consultative Paper 23.

Finally, the Government Intervenes

On October 7th 1990, Trade and Industry Secretary Peter Lilley asked the SIB to revise its rules on the disclosure of commissions. Lilley was responding to three pressures:

- The first was a report by the OFT, published in the Spring of 1990 titled 'The Disclosure of Information about life products and commissions paid to independent financial advisers' which was part of a continued and sustained effort by the 'competition watchdog' for hard disclosure.[447]

- He was also reacting to media and consumerist pressure for hard disclosure which was made all the more damaging in light of the financial scandals that had plagued the first two years of the regime's operation.

- Finally, he was reacting to the alarming rise in commission levels since the demise of the MCA in 1989. Commissions had risen by 70% over the year and witnessed a declining but positive rise over the period 1991 – 1993. The rise in commission levels is illustrated in the data below:

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[447] The OFT particularly wanted to see the confusing reduction in yield figure to be replaced with a hard cash figure.

The data are expressed as a percentage of the maximum commission level. 150% of LAUTRO thus represents a commission level 50% above the MCA level.

Commissions paid to IFAs on a 25 year endowment policy

March 1990: 123% of LAUTRO
November 1991: 126% of LAUTRO
August 1993: 128% of LAUTRO

Commissions paid to appointed reps on a 25 year endowment policy

1990: 134% of LAUTRO
1991: 144% of LAUTRO
1993: 146% of LAUTRO

In the absence of hard disclosure, and with fierce competition for distribution within the investment industry, there was no bar to the escalation of commissions. This was bad news for the investor and for Lilley who was roundly criticized in the industry, by consumerists and in the media. Lilley thus followed the advice of the OFT who were arguing that hard disclosure of commissions and charges would allow consumers to exert competitive pressure to restrain the growth of commission levels. The industry sought to resist the introduction of hard disclosure; commission was the most effective tool by which the life offices were able to capture and retain distribution. SIB supported the industry in its opposition to hard disclosure and its final recommendations fell far short of hard disclosure.

SIB responded to Lilley's directions by publishing another consultative document in late 1990 (Consultative Paper 30). It had also earlier established a new committee: The Quality of Information Working Party but this had become bogged down in "...attempts to reinforce the old policy, which had proved inadequate."[448] SIB further announced its intentions to publish two more consultation papers on disclosure.

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[448] Jebens, Sir Kit, *op. cit.*, p.44.

LAUTRO also published a paper (CB4) in which it advocated a three-stage regime for disclosure:

- Investors would be provided with essential information before committing themselves to the contract. This would take the form of a Key Features document.
- Investors would also be provided with important information, but information that was not critical to the purchasing decision, pre-cancellation notice sent by the product provider.
- Finally, investors would be provided with additional 'useful' information which was neither essential for purchase decisions or for cancellation decisions.

However, despite the LAUTRO proposals, industry opposition to disclosure remained.

Industry Opposition to Disclosure

The industry was implacably opposed to radical reform to the rules on commission disclosure. As Jebens states "Industry practioners were opposed to the accelerated introduction of disclosure both on the grounds of cost and because of the technical difficulties of achieving a consensus on formulae which could deliver accurate information about a wide spectrum of different products in a standard format"[449]. The industry also had another reason to oppose disclosure: there was a strong body of opinion in the industry which stated that if consumers knew the extent of the commission that they were paying there would be collapse in demand within the industry.

SIB finally published new proposed rules on disclosure in its Rules Bulletin 53. In March 1993 the OFT published a report, which raised no serious objections to the SIB proposals, but proposed two important additions.

- That there should be hard disclosure for IFAs but not for tied agents.

[449] Ibid.

- Also, that data on persistency rates should be included in the key features document.

On July 22nd 1993, it once again took political intervention, in the form of the Chancellor, Kenneth Clarke, to tell SIB to draft new rules giving buyers of life policies more information. On 31 December 1993 the new disclosure regime was introduced for IFAs and for tied agents. However, pressure in the media and from IFAs for hard disclosure of commissions for tied agents mounted. This was because disclosure of commissions by IFAs without parallel disclosure for tied agents would put IFAs at a significant disadvantage. An analogue was thus developed for tied agents of IFA commission. Hard disclosure requirements for both the IFA and the tied agent were introduced on the 1st of January 1995 after SIB published Consultative Paper 77 (January 1994), where it stated *again* that an "...essential feature of investor protection is timely and clear disclosure of information to investors: how the product works, what it costs, and what the advice costs."

The requirement was for:

- Disclosure of the product provider's own charges and expenses, and how they affect the value of the investment. As with projections of future benefits, these based on standard LAUTRO figures.

- Disclosure of surrender values, to make clear the effect of early surrender.

- Commission or equivalent paid to the salesperson should be disclosed in cash terms to enable investors to identify the incentives of salesmen. An IFA discloses commission in cash terms, a salesman working for a life assurance company or its appointed representative discloses 'commission equivalent' which takes into account any payments received and benefits and assistance provided.

- Any forecast or illustration of benefits must comply with detailed rules, and be based upon the costs and projections calculated by each product provider - not on an industry standard as before (which was meaningless).

A Public Choice Analysis of the Disclosure Saga

The disclosure saga illustrates several failings of the FSA regime. It illustrates the industry's brilliance for obfuscation and filibustering when faced with rule changes that were opposed to its interests. It also illustrates the failure of the regulators to tackle the industry and serve the investor. The ex head of LAUTRO, Kit Jebens surprisingly admits "Disgraceful would not be too strong a word to describe the length of time from the moment in June 1991, when the three stage system and what came to be known as the Key Features document was first designed, to 1st of January 1995 when the system, with relatively little change, finally became mandatory."[450] Moreover, he also admits that "...the industry fought every inch of the way, losing credibility with the public and costing itself enormous sums to implement a series of lesser changes where one radical but cheaper and less confrontational step might have been achieved"[451].

The way in which in the early days, the SIB supported the life offices (and FIMBRA and LAUTRO[452]) in battling with the OFT against hard disclosure, further illustrates the failure of SIB to serve investors' interests. It took seven years of sustained pressure for hard disclosure rules to be introduced. SIB's main arguments against hard disclosure were that investors would be unable to comprehend the information disclosed, and that disclosure would lead to a significant reduction in demand in the industry.

The first argument, supported most publicly by the ex-CEO of the Prudential, Mr Mick Newmarch, ignores the points that many consumers are able to understand this sort of information, and that those who don't can always seek advice from people who do. It also ignores the fact that, to the extent that consumers do have difficulty understanding this information, it is to a considerable extent because the sellers of financial products make this information deliberately difficult for consumers. Firms could make contracts understandable to their customers by simplifying them and by providing more straightforward information to their clients. However, the reality was

[450] *Ibid.* p.48.
[451] *Ibid.* p.23.
[452] As Goodhart et al (1993) argue "The recent discussions on disclosure in life insurance shows clearly, to us, that LAUTRO, the SRO for the life insurance industry, (and the SIB) are reluctant to be tough with themselves as practitioners. Only the Office of Fair Trading (OFT) , an independent organization, has come out strongly in favour of disclosure." (Goodhart et al, 1993, p.6).

that many firms sought to confuse their customers so that they could get the better of them. As the Treasury and Civil Service Committee report of 1994 made clear

> ...we regard as arrogant and unjustified the contention that investors would not understand the significance of a saleman's commission or the difference between the sum paid over to a life office or other product provider and the sum invested for the client's benefit.[453]

Moreover, they stated that "...we consider it a failure of regulation until now that LAUTRO have prevaricated on this issue for so long."[454]

The second argument is even less persuasive. The regulators were arguing that consumers should be kept in the dark (and therefore left open to excessive charging) because informed consumers would not stand for it. In other words, consumers should not be informed because they would realize they were being overcharged – this is a novel argument for regulators whose *raison d'être* was to protect the consumer.

The regulators only accepted disclosure when the Government finally forced it on them in 1995. However, regulators then changed tack and now claim that disclosure was one of the main *achievements* of the regulatory regime. As Simpson argues

> From 1986 onwards, the SIB, urged on by the industry, fought a rearguard action against the OFT's recommendation requiring companies and agents to disclose to consumers information on the prices and commission payments they received on policies sold. ... the SIB was able to hold up the development of price competition in the industry for almost nine years. [Yet] Today, the same organization unblushingly identifies disclosure as one of the principal measures for investor protection.[455]

Disclosure was a clear case where the interests of the industry and those of the consumer were opposed, and in the early days at least, the regulators sided whole-heartedly with the industry. A clearer case of regulatory capture is difficult to imagine.

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[453] Treasury and Civil Service Select Committee, Fourth Report, "Retail Financial Services Regulation: An Interim Report", 23rd May, 1994. London: HMSO.
[454] Ibid.
[455] Simpson (1996), *op. cit.*, p.45.

6. Training and Competence: The McDonald Report

As discussed earlier, the initial FSA regime laid down no specific requirements as far as training and competency were concerned. However, in August 1989 SIB commissioned Dr Oonagh McDonald[456] to conduct a review of standards of competency in the industry. She reported in May 1990 and found a "...mixture of the impressive and the insufficient..."[457]. She further commented that

> In some cases, it is apparent that too little time and thought is being given to the adequate provision of training; in other cases resources and facilities of worth to individuals engaged in investment business activities are available but use of them is voluntary where it ought to be mandatory...; in other cases what is available is focused too narrowly to give any reasonable assurance that the individuals concerned will be equipped to operate to the standards expected by the regulators. And generally speaking the initiatives and arrangements in hand seek to meet differing objectives with differing standards, there being no firm indication as yet of the regulators' expectations.[458]

This was a damning critique, and she recommended that "...SIB and [the] recognized bodies should address these with a view to making clear what standards they expect from firms in respect of the individuals engaged within the firm on investment business activities."[459] She made three general recommendations and four specific ones.

McDonald first proposed, that "...responsibility for ensuring proper standards of service within investment businesses must rest with the bodies regulating those businesses."[460] Second, she advocated the establishment of generally consistent regulatory objectives between the different regulators and also that the quality of service delivered to the consumer "...should not be permitted to fall below an acceptable level in any case."[461] Finally, she recommended that each of the regulatory bodies be given the task of implementing (a) the standards which would underlie its involvement in ensuring competence, (b) means by which its regulatees could

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[456] A former Member of Parliament for Thurrock, frontbench spokesman on Treasury and Economic Affairs and, at the time of writing the report a Senior Research Fellow at the University of Warwick)

[457] McDonald, O., (1990), "Training and Competence in the Financial Services Industry", (London: SIB), p.11.

[458] McDonald, O., *op. cit.* p. 67

[459] McDonald, O., *op. cit.* p.16.

[460] McDonald, O., *op. cit.*, p. 69

[461] Ibid.

demonstrate possession of requisite competency standards, (c) the means by which it could ensure that the required levels of competence existing in practice and not simply on paper.

She argued that the above criteria would form an additional measure of regulatory effectiveness in periodic monitoring.

In addition to her general recommendations, McDonald also advocated specific suggestions in terms of recruitment practices, training arrangements, supervision arrangements and incentive and disciplinary arrangements.

In terms of recruitment practices, which had traditionally been based on the 'looking glass test', McDonald advocated a far greater degree of rigor, including making proper reference checks and investigating gaps in the employment of prospective salesmen. She also recommended the keeping of thorough records on employees.

Regarding training arrangements, McDonald recognized the critical importance of competency (including both knowledge and understanding) for investor protection, and more specifically in order to meet the suitability requirements of the rules. She identified a trend, within in-house training schemes of simply "...instilling knowledge of the products of the employer and training them how to sell them,"[462] rather than focusing on assessing and meeting the needs of the client.

On the issue of supervision, she argued for close, personal supervision of new recruits and for the monitoring of the track record of relatively new recruits, particularly in terms of persistency rates.

Finally, on the issue of incentives and disciplinary arrangements, McDonald stressed the importance of establishing "...thorough supervision and quality checking..."[463] arrangements to ensure that individuals act within the bounds of competence and integrity. For cases where shortcomings were identified, procedures should be put in place for education of re-training. McDonald was insistent on the need to address the practice, within many life offices of rewarding salespeople with commission-only remuneration packages. In particular she identified the practice within many organizations of not only paying new recruits on a commission-only basis, but of permitting them to sell only a limited range of 'simple' products. As she

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[462] Ibid.
[463] Ibid.

argued "Not only do such recruits have a financial incentive to sell their employer's products regardless of their suitability..., the incentive is confined to a narrow range of those products. Such incentives do not sit comfortably with the duty of a firm to ensure suitable advice."[464]

McDonald argued that within three or four years "...all individuals employed in the investment business industry would...need to possess or work towards a 'regulator recognized' qualification."[465].

The first possibility of a 'recognized qualification' for investment business practitioners was to come in 1990. In 1990 the Department of Employment established the Sales Qualifications Board (SQB) as the lead body with the task of designing, developing and implementing National Vocational Qualifications (NVQs) in Sales and Sales Management. The financial services industry was identified as one of the sectors (especially the constituency of LAUTRO and FIMBRA) that might benefit most from the NVQ qualification because they provided an opportune means of complying with the admittedly vague competency requirements in the FSA and in the rules of the SROs. However, LAUTRO (arguing that it was "...not a matter for them to recommend a particular method by which objectives were to be achieved..."[466]) and FIMBRA (which refused to discuss the matter[467]) both rejected the SQB's approaches, having presumably canvassed their members.

The Financial Planning Certificate

After long delays, and the failure of the NVQ initiative, on January 1st 1993 LAUTRO introduced a training and competence scheme based on the Financial Planning Certificate, written by Keith Popplewell, and the scheme was given final approval in August 1993. The FPC was a knowledge based course and the general standard was little above that of GCSE. Indeed, Michael Drakeford[468] a director of Midland, candidly stated "Now some people...say that they [the FPC exams] are really pretty low GCSEs compared to say an accountancy exam, or legal or even bankers qualifications which take years to get, they're a bit easy, but having said that, they're

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[464] McDonald, O., *op. cit.*, p.18.
[465] McDonald, O., *op. cit.*, p.74.
[466] John Cater, Submission to PIA Evolution project, May 1997, p.6.
[467] McDonald, O., *op. cit.*, p.76.
[468] Michael Drakeford, Midland UK Compliance Manager, interview 19th February 1998.

better than nothing" and Arthur Selman[469], Compliance manager of Halifax commented "...there is still a long way to go. I mean look at the FPC...it's not rocket science, is it?"

Despite the introduction of FPC the industry continued to argue against mandatory requirements to have their salesforces qualified to FPC3 standards.[470] Barbara Saunders[471] argued "Undoubtedly, the absence of a training and competence regime until the last few months has been a serious gap... [A]t the time of the formation of the PIA...leaders of the industry were saying categorically that it was ludicrous for tied salesforces to have more then FPC1." Phil Telford[472] said "The industry didn't want to know, of course not, they didn't want to have to go through the extra expense of training people, you know they would train them to sell but not to be trained to take exams or to pass qualifications set down by the regulators for example..."

In addition to opposition from the industry, the regime was not without other critics. The Head of LAUTRO, Kit Jeben's argued "...the national press seized upon the fact that training and testing would be carried out by the firms themselves and questioned whether they could be trusted."[473] Again, the firms themselves were to be trusted with their own regulation.

A Public Choice Assessment of the Training and Competence Saga

The industry's repeatedly proven talent for obfuscation succeeded in postponing the date for the introduction of a requirement for salesmen to reach the minimum FPC3 requirement until July 1997. This was seven years after McDonald had reported. The failure of the regulators to introduce a quasi-professional standard of competency was the result of two factors. The first of these factors was the industry's opposition to such requirements. Opposition was particularly voracious from the direct sales side, where as was illustrated in the earlier quote from IFAA Chief Executive, Gary Heath, their primary concern was with minimizing their costs of distribution.

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469 Arthur Selman, Compliance Manager Halifax Life, interview 24th February 1998.

470 FPC3 was the only examination of the three which actually tested the application of knowledge rather than simply the regurgitation of learned 'facts'.

471 Barbara Saunders, Chair of the PIA Consumer Panel, interview 31st March, 1998.

472 Phil Telford, Senior Researcher, Consumers' Association, interview 9th June 1998

473 Jebens, K. *op. cit.*, p.59.

The second factor was the regulators willingness to placate the industry. As Gary Heath[474] again argued

> Both individual registration and T&C in my view, if someone had come along to me and said 'Gary, you're doing the job [of designing a new regulatory regime], what do you want to do?' That would have been the way I did it [i.e. implement training and competence requirements and individual registration rules]. They did neither. And that was a good example, I think, of the industry getting in the way. Because originally Oonagh McDonald came out with a report for SIB and the SIB members I think – the individuals from the larger banks and what have you – basically took one look at it and basically sent it back! And said 'Come up with something a lot less poisonous'.

Although the regulators did finally come to grips with this issue and introduce a requirement for all advisers to reach a minimum level of competency, the failure of the regulators to do this until 1997 was another a case of capture.

7. The Personal Investment Authority

In 1995, after seven years of problems, scandals and wrangling, the SIB and Government took the major step of replacing LAUTRO and FIMBRA with a new regulatory body, the Personal Investment Authority (PIA). Before considering the effectiveness of the PIA, I shall begin by charting its origins, by reviewing the New Settlement, through to the Large report and eventually to the report conducted by Sir Kenneth Clucas.

<u>The New Settlement Reforms</u>

As was discussed earlier in the context of the appointment of David Walker as SIB chairman, in 1989, when Walker took over from Kenneth Berrill, there began a series of reforms that came to be known as the New Settlement. Four pivotal changes were made in 1989 as part of the New Settlement liberalisation of the regime:

- The SIB was given the power to state essential or central requirements, on a unified basis, leaving it to the other regulatory bodies to create for

[474] Gary Heath, CEO of the IFA Association, interview 8th April 1998.

themselves the supporting detail which they might find desirable. The SROs were thus given considerable discretion in their rule making.

- There was a softening in the investor protection requirements of the SRO rule books from a test that demanded *equivalent* investor protection to the SIB rules (an objective test), to a test that demanded that the SRO rules gave investors *adequate* protection (a subjective test).

- There was a supposed move away from a prescriptive rule based approach to regulation to one based on a framework of simplified core rules, principles and guidance. Ten principles (implemented in April 1990) and forty core conduct of business rules (implemented in 1991) were instituted along with a third tier of more detailed and specific guidance rules (which were legally enforceable) and codes of conduct (which were not legally enforceable).

- There was also an abandonment of the legal right of the professional investor to sue for any breach of the regulatory framework which had been enshrined in section 62 of the act.

The New Settlement Reforms, as Large was later to confess, failed largely to achieve any significant improvements in the levels of investor protection. What it did do was to give the industry even greater control of regulation. The change from 'equivalence' to 'adequacy' was a considerable weakening in the duty of the retail SROs. The trade association regulators were given virtual carte blanche to determine what was 'adequate' protection. It is perhaps no surprise that, as is demonstrated in the following chapter, they interpreted this duty rather loosely.

The other changes enshrined within the New Settlement were also biased towards the interests of the industry. The move to less prescriptive rules was another part of the change towards greater discretion for the SROs in their rule making. In addition, the right of professional investors to sue for rule-breaches, enshrined in Schedule 62 was abandoned. Although the right of non-professional investors to sue was left open, the likelihood that this was ever going to happen was remote. However, the threat of professional investors suing was very real, indeed it was on this point that the industry lobbied vociferously during the first few years of the Act's operation. The removal of this right was thus a major concession to industry demands.

Only two years after the New Settlement reforms had begun, a further series of revelations about wrong-doing in the investment industry precipitated another series of reforms to the regime.

The Large Report

Two SIB reviews into the system of regulation reported in December 1991. Both revealed the details of Robert Maxwell's thefts from the Mirror Group pension funds. IMRO was severely criticized in the report for being inflexible, uncritical and for failing in its monitoring responsibilities. SIB also accepted criticism for its failure to recognize the weaknesses at IMRO. The revelations over the Maxwell scandal led the Government, in July 1992, to commission Andrew Large, Chairman of the SIB, to conduct a whole-scale review of the FSA regulatory regime. Large cited eight criticisms made on the FSA system generally and a further six made on SIB specifically. The general criticisms were devastating.

- The objectives of regulation are unclear.
- Self-regulation equates with self-interest.
- Cost-effectiveness is not evident.
- Too much fraud goes unpunished due to the regulators looking in the wrong direction.
- The system is too complex.
- The retail area is ineffectively regulated.
- Regulation of professionals is not sufficiently distinguished from that of retail regulation.
- The compensation scheme is unfair and badly structured.

The specific criticisms on SIB were also powerful.

- Its role is unclear.

- It has not "…developed an adequate system of supervision of the other regulatory bodies."[475]
- Enforcement activities are not understood or visible.
- Resources are inadequate and the structure is inappropriate.
- It has not led the system sufficiently or set standards.
- Its accountability is remote.

Large's report was published in May 1993 and, despite the highly critical comments received during his consultation, the report was far less critical than many commentators had expected.[476] Fundamentally, Large stressed that the basic structure of regulation was correct and that in general regulation did serve the investor. However he did recognize that there was concern that cost-effective investor protection was not always achieved. He also found, as I have argued, that the goals of regulation had become a little confused. He thus emphasized that the goal of regulation was to provide a clean market in which the investor could make informed decisions, it was not the role of the regulator to eliminate risk altogether – also the costs of regulation would have to be considered more closely.

Large also found that the New Settlement changes inspired by David Walker, had not worked as effectively as intended. Whilst acknowledging that the New Settlement's clear, written rules were preferable to the highly detailed legalistic ones originally in force before, it was recognized that SIB had retained too great a role in the rule-making process and had failed to supervise adequately the SROs[477].

Large therefore proposed four changes:

1. SIB would set standards, and establish 'goal posts' for SROs, and their performance (in terms of the adequacy and effectiveness of regulation) would be judged against these standards.

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[475] Large, Andrew (1993) "Making the Two Tier System Work" , p.8.
[476] Although perhaps not surprising since he was the SIB Chairman!
[477] In fact Large found that the primary weakness of the FSA was down to "SIB's lack of direct enforcement powers over a firm regulated by a recognized body, of focused powers to support SIB's role of supervising recognized bodies, and of powers to determine SRO scope and restrict the opportunity for firms to be directly regulated by SIBRO." (Large, 1993, p.5).

2. SIB would supervise and monitor the SROs "systematically and fairly"[478].

3. SIB would utilize its enforcement powers more frequently.

4. SIB would withdraw from rule-making and direct regulation. Writing rules diverted SIB's attention away from its pivotal supervisory role and its role in regulating a few firms conflicted with its role as a supervisor of other regulators.

SIB implemented these proposals in the following ways:

- SIB endorsed the creation of PIA as the retail regulator.

- Firms regulated directly by SIB were to be encouraged to become regulated by SROs – especially PIA.

- SIB prepared statements of objectives for each SRO, who have then prepared regulatory plans setting out how these objectives are to be achieved.

- SIB exercised its powers under schedule 59 to prohibit the employment of people for the first time.

- SIB de-designated its core rules (which were never applied by the retail regulators).

The Clucas Report

In the wake of growing revelations about pensions mis-selling, in October 1991, yet another review of regulation was begun by the SIB into the regulation of the FIMBRA and LAUTRO constituency. Out of this arose the Clucas Report, published in March 1992. Clucas, an ex-civil service mandarin, was set the task of examining whether a single regulatory body (an SRO) should be formed for retail regulation. His terms of reference (set by SIB) were to have due regard to the requirements of the FSA, but to

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[478] Morris, S. (1995) *Financial Services: Regulating Investment Business,* (London: FT Law and Tax), p.12.

consider whether the formation of a new SRO was appropriate, and if so, to outline a mechanism and time-scale for its implementation.

Clucas was asked to work within the constraints of the existing statutory framework and to give due regard to:

- the continued delivery of high standards of investor protection;
- the continued availability to consumers of a wide choice of financial advice;
- the importance of self-regulation, that is, of those who are regulated having sufficient responsibility for, and commitment to, the development and implementation of regulation; and
- the importance of cost effective regulation.

Clucas drew the inevitable conclusion that "...a new SRO should be created to regulate investment business primarily done with or directly for the private investor"[479]. Clucas identified a number of reasons why a single regulator for the retail side of financial services was desirable. First, he cited the complexity and overlap that existed in the existing institutional structure. He pointed out that different retail institutions could be regulated by as many as five possible different regulators:

- Packaged products providers and their agents: regulated by LAUTRO, IMRO and SIB.
- Insurance and unit trust brokers: regulated by FIMBRA, IBRC, SIB.
- Independent financial advisers: regulated by FIMBRA, IMRO, SFA, RPBs, SIB.
- Private portfolio managers: regulated by FIMBRA, IMRO, SFA, RPBs, SIB.
- Stockbrokers: regulated by SFA.

The confusion synonymous with the regime was due to the way in which the structure was designed around existing trade associations, which meant that the regulatory structure was organized on a functional rather than institutional basis. The consequences of this were considered earlier, but to recapitulate briefly, the

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[479] Clucas, L. *op. cit.*

institutional structure meant that (i) the practical task of regulating and especially of achieving compliance was made a great deal more difficult; (ii) the abundance of regulators with overlapping coverage exposed the potential for regulatory arbitrage, was worsened by the availability of the SIBRO option; (iii) it made things even more complicated for the investor who had no single point of entry into the system. The establishment of a single retail regulator would have obvious practical advantages in terms of stream-lining this structure, it would also reduce the potential for regulatory arbitrage and provide the investor with a single point of entry to the system.

A second critical reason for the establishment of the PIA was that FIMBRA was on the verge of financial collapse, and had been for some years. The life offices were having to support FIMBRA's compensation claims before 1991, and in 1991, LAUTRO agreed to assume some responsibility for FIMBRA's costs. For the period 1988 – 1992 FIMBRA members accounted for £34m or 76% of total compensation costs. However, unlike LAUTRO members that were, on the whole the hugely resource rich banks and life offices, FIMBRA members[480] did not have the resources to cover compensation claims. A serious compensation claim would easily wipe out a typical FIMBRA member and, combined with the escalating costs of regulation which reached £330m in 1995, FIMBRA's constituency atrophied. Both LAUTRO and FIMBRA were funded wholly by their members so by the early 1990s, FIMBRA faced rapidly declining membership combined with ever rising compensation costs. With the pensions scandal slowly emerging, it was clear by the time that Clucas was commissioned that FIMBRA had no long-term future.

A third reason for the formation of the PIA was the succession of scandals that occurred over the first five years of the FSA's operation, and the apparent failure of FIMBRA and LAUTRO to enforce the rules meant that neither body held the confidence of the public or the media. Both LAUTRO and FIMBRA had been condemned as trade associations by the media and by consumerists and it was increasingly clear that the *self-regulatory trade association* model for regulation had failed to deliver investor protection. Just as at Lloyds, the practitioners had put their own interests first. Neither LAUTRO nor FIMBRA had any meaningful consumer

[480] Where the firms on average were very small with many one-man operations.

input[481]. The PIA was supposedly to be the consumers champion, and was sold to a large extent on consumerist involvement in decision making.

The Back Ground to the PIA

Despite Clucas's recommendations, which received approval from SIB in 1992[482], the birth of the PIA was a difficult one. Although, as was widely reported at the time, "[a] powerful single regulatory body seemed ultimately to be inevitable,"[483] there were formidable stumbling blocks in the way of its practical formation and the troubled origins of the PIA were to have a profound influence on the ultimate effectiveness of the body.

The banks and life offices (at SIBRO) had very little incentive or inclination to join a new regulatory body, especially as the regime at SIBRO seemed rather lax. The banks were also concerned that if they did join a single retail regulator, they may be marginalized by the life offices who would inevitably dominate in terms of seats on the board. The banks and life offices who were at LAUTRO also had little incentive to join a new 'all encompassing' regulator. They did not wish to join the rag tag and bobtail of FIMBRA membership at the PIA who they would inevitably be forced to subsidize given the proposed fee levying structure. LAUTRO members had also enjoyed being *regulated* by a trade association and were far from keen on the move.

The threat of the SIBRO members not to join a new retail regulator combined with the announcement on the 24th March 1994 by the Prudential that it would be joining SIBRO rather than the PIA. This announcement seriously threatened the credibility of the new regulator to the extent that even as late as the Treasury and Civil Service Committee inquiry in 1994, there were grave doubts as to whether the formation of a new retail regulator would be possible.

There was also opposition to the establishment of the PIA from the independent financial advisers of FIMBRA. FIMBRA members, who had been regulated by what was *de facto* a trade association, were concerned that their interests would be marginalized in a body which would inevitably be dominated by the banks

[481] LAUTRO, nominally had seven public interest directors on its Board but they were not consumerists.

[482] In April 1992, the chairman of SIB and the SROs appointed a formation committee to develop Clucas proposals. SIB then notified the newly formed PIA in January 1993 as to the standards it would require.

[483] The Financial Times, "Biggest banks Reject Proposed Watchdogs", 10th September, 1992.

and particularly the life offices[484]. FIFA, the Federation of Independent Financial Advisers, attempted to arrange a whole-scale boycotting of the PIA by IFAs. Even as late as March 1994, IFAs were advised by Gary Heath, the head of the National Federation of IFAs, to delay their applications to PIA in order to wait until PIA's future was more certain. In practice however the IFAs had little practical choice. If the PIA was born and the big players were on board, FIMBRA would be slowly wound down and IFA members would have to join the new body.

Concessions to Private Interests

In order to achieve the critical task of getting the life offices and bancassurers on board, the PIA offered them a number of concessions. As Gary Heath[485] argued "...when the banks came into PIA, the first thing they asked for was an 18 month delay on training and competence." In addition, plans for individual registration were temporarily shelved and a measure demanding minimum capital adequacy for all firms handling client funds was introduced.

The proposal for an 'own-funds' capital adequacy requirement of £10,000 was greeted with fury by the IFA sector, which believed that it could cause 50-60% of the small IFAs to become insolvent. The IFAs were already deeply concerned that the product providers were winning the battle for control of the new body. The resignation of Sir Gordon Downey (the ex-FIMBRA Chief Executive) as Chairman of PIA in September 1993 was viewed as highly significant by the IFA community. His resignation was widely reported in the press as being because he had been unable to restrain industry interests on the board. His departure followed growing concern at the SIB that the PIA board had been too willing to concede to powerful interests in drafting its operating guidelines. However, to the IFA community, the loss of Downey was highly symbolic of how IFAs might fare within the new regime.

The apparent success of the product providers in influencing the PIA during its gestation period brought with it criticisms from the media and from consumerists. Most outspoken was Jean Eaglesham of the Consumers' Association. She stated in an interview with the Independent's William Kay in January 1994 that

[484] The two seats given to IFA representatives both went to the large intermediaries.
[485] Gary Heath, CEO of the IFA Association, interview 8th April 1998.

> We have been dismayed by the way in which the evolution of the PIA has been sidetracked by industry interests. People like ourselves have had virtually no input into the debate, and industry interests are often opposed to consumers. Although Mr Palmer...wants 10 of the 19 directors to be 'public interest' directors who do not work in the industry, those named are hardly representative of the small saver.[486]

The make-up of the PIA rule-book, which was published in 1994, also attracted criticism from the OFT. It considered that the capital adequacy requirements for IFAs could have a significant damaging effect on competition and choice. The DGFT also expressed concern over the controls that would prevent the employment of salesmen who owed more than £1000 to life companies; and over the proposed rules which would require varying levels of professional indemnity insurance.

The make-up of the PIA board was also to prove a highly contentious issue. The initial proposal, influenced strongly by SIB Chairman Andrew Large was for a board with nineteen members, ten of which would be 'public interest' members. The PIA was being sold as representing a break from the traditional trade association model of a regulatory organization. FIMBRA and LAUTRO had been dominated by practitioners and, as such had been discredited. The PIA was to be dominated by public interest members, as such it would command the confidence of the public. However, the proposal for a 'public interest' dominated board was greeted with derision by the industry, which almost universally condemned it as being a betrayal of the self-regulatory foundations of the Act. Two of the biggest life offices, the Prudential and Standard Life argued vociferously for there to be a majority of practitioners on the PIA board. In January 1994, Jim Stretton, Deputy Managing Director of Standard Life resigned from the PIA Board in protest at its makeup.

Once again the industry was to have its way, for despite the publicly stated position of Andrew Large that the PIA should have a board comprising a majority of public interest members, industry opposition caused a climb-down. The PIA eventually announced in late 1994 that the Board would actually comprise of twenty-one members, ten of whom were to be 'active practitioners', ten were to be so-called 'public interest' directors and – according to PIA – there was to be an independent Chief Executive. The Chairman of the PIA was to count as a public interest director.

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486 The Independent on Sunday, "New Investment Watchdog Under Fire From All Sides", William Kay, 30th January, 1994.

In fact, despite the rather novel protestations of the Chief Executive of the PIA, Ms Collette Bowe, that she was neither a public interest director nor a practitioner but in a third category which was "...to represent the interests of the PIA."[487] under the terms of the Act, the Chief Executive of the PIA was *de facto* regarded as a practitioner member of the Board. Thus, despite the gloss given by SIB, PIA and the Government, the Board was actually be to have a majority *practitioner* membership. As Andrew Large was forced to admit to Parliament in 1993, the makeup of PIA's board did not "technically"[488] meet SIB's requirement. This was a huge concession to industry interests and displayed very clearly the capture of the system by practitioners.

The climb-down over the make-up of the PIA board was to be compounded by the announcement that the Chairman of the PIA - who was to count as a public interest member of the Board – was to be none other than Mr Joe Palmer. The Chairman had a position of great power on the PIA Board for the reason that decisions were made not on the basis of votes but based on the Chairman's opinion of the general tenet of the meeting[489]. However, Mr Palmer's public interest credentials were, to say the least in some doubt. He had previously been Chief Executive of the Legal and General until September 1991 and had held senior positions on the company since 1969[490]. His position as Chairman was made particularly embarrassing by the announcement by LAUTRO in March 1994 that it was imposing a record fine of £180,000 plus £220,000 costs on the Legal and General for *widespread and systematic failure to comply with regulatory requirements* specifically in relation to pensions mis-selling. The period of failure covered July 1991 to October 1992; Palmer had been Group Chief Executive of the Legal and General from 1984 to October 1992. Palmer was also in charge of the Legal and General when it took a 4.9% stake in Roger Levitt's group and there were also suggestions that Palmer was closely involved in the establishment of 'Homes Assured' which was established in the mid 1980s to help council tenants to buy their homes. This company traded

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[487] Treasury and Civil Service Select Committee (1993-1994), "Financial Services Regulation: The Personal Investment Authority", Mr J. Palmer and Miss C. Bowe, p.277.

[488] Treasury and Civil Service Select Committee, (1993-1994), "Financial Services Regulation: The Securities and Investment Board", Mr A. Large and Mr M. Blair, p.300.

[489] As Gary Heath commented "...they never take a vote. It is based on what the Chairman believes the tenet of the meeting seemed to be. You can imagine how that works! Especially when you've got the chairman and the chief executive flying in sympathy."

fraudulently and eventually went bust owing £9m. As Mr Brian Sedgmore summed up after grilling Mr Palmer in the 1993/94 Inquiry:

> You were head of an organization whose policies were being sold by untrained staff...you were at the head of an organization where those who sold the policies were supervised by dishonest managers...you were the head of an organization where a senior manager conspired not to tell LAUTRO what was going on...you were head of an organization where there were no systems for checking what was going on, and that effectively you were the head of an organization which did not know right from wrong?

The notion that the PIA was somehow a break from practitioner domination of regulation was difficult to accept. As the Consumers' Association argued in 1994,

> Self-regulation, equating with self-interest, also leads to weak regulation...[An example is] the way in which the evolution of the PIA has been delayed and marred by the infighting of various industry vested interests, culminating in its potential sabotage because life companies cannot tolerate a board where the industry does not have an outright majority.[491]

The Board was majority practitioner, its chairman was a practitioner (and one with questionable ethics at that) and in the process of trying to attract the big players into the PIA fold numerous concessions were granted in terms of the PIA rulebook.

The Birth of the PIA

The PIA finally came into full operation on June 22nd 1994. The PIA set forth its raison d'être thus. Its task was to

- reinforce high standards of integrity, fair dealing and competence;
- make full and proper use of the powers available to protect investors;
- set rigorous standards of training and professional competence;

[490] Mr Thomas Joseph Palmer CBE, had also been a director of the Sedgwick group (1992-1993) and on the board of the Association of British Insurers (1989-1991).
[491] Consumers' Association, Evidence presented to the Treasury and Civil Service Committee Inquiry into Financial Services Regulation. Session 1993-1994. Wednesday 23 February 1994, p.45.

- help investors to protect their own interests by establishing demanding standards of relevant disclosure; and
- provide effective mechanisms for handling of investor complaints and for securing redress for investors who have been disadvantaged

However, despite these grand words the PIA was to be beset with four major problems. First, in its desire to compromise to industry demands it failed adequately to come to grips with a number of the significant problems which it had supposedly been created to solve. The starkest case of this was the pensions review which is considered in the following chapter. Other examples of the PIA's reluctance to challenge the power of the industry included the FPC exam which, as was argued above was too easy and even then salesmen failed to pass the exam on time (and so the PIA gave them extensions) or resorted to cheating, aided and abetted by their employers. A further example is that of individual registration. Consumerists had called for this from day one, and it would have required that all people selling investment products be properly registered and vetted. According to its proponents, it was a means of preventing rogue salesmen leaving one life company and simply being employed elsewhere. As Gary Heath argued:

> ...we wanted to see a situation where if you've got a con-man in their sector, he couldn't come into ours without us knowing about it. And we had lots of examples of that – where people had been direct salesmen with one particular company – with very credible people – and they've been chucked out of their insurance company for stealing money, or fraud or something like that. And because, it is obviously not the sort of thing that finds itself into the references, we didn't know about it. So you'd take on somebody and then find that they'd defrauded your clients, so as small businesses, we really need some method of policing that.

However, individual registration was opposed by powerful elements within the industry (the life offices and banks opposed it on cost grounds) and the SIB and PIA accepted their line until they were finally forced to change their policy in 1997. As was argued at the Treasury and Civil Service Committee Inquiry in 1997, it took the Select Committee's intervention in 1993/ 1994 to force the regulators to adopt individual registration.

A further example of the *industry getting in the way* was over the vexed problem of commission bias and disclosure. Pressure from Parliament forced the PIA to finally introduce hard disclosure for all insurance salesmen from 1st January 1995[492]. However, the way in which the data were to be presented to investors in the complex reduction in yield format combined with the increased complexity of the charging structures on policies to mean that products were as opaque as ever. In the absence of product regulation, insurance companies simply increased the complexity of their products to compensate for the disclosure requirements.

<u>Rules Escalation and Bureaucracy</u>

A criticism of the PIA was that it tended towards being excessively bureaucratic. Three pressures drove a pronounced trend towards rules-escalation. As IFA Network Chief Executive, Nick Ansell argued

> I mean if I look at the sheer volume of stuff that we have to keep on top of – I mean if you look at FIMBRA existence, I can't remember exactly but there'd have been about 20 rule amendments or whatever, maybe, I don't know how many, what are we up to, in the entirety of FIMBRA's existence we had 19 rule amendments, we had 16 guidance notes and 29 briefings. I think already under PIA we are up to, where are we up to, we're up to rule notice 34, we're up to regulatory update 46 and it's all just quite absurd, it's simply a factor of the volume of bumf being pumped out that, consultative papers – I mean that ignores all of the consultation papers, all the consultative papers and discussion documents and God knows what – you've got compliance departments of that size to fulfill all of the functions being asked for by PIA really.[493]

A first reason was that in the PIA's desire to deflect escalating media attention to regulatory failure it responded with ever more rules and rule-changes. As Goodhart has argued, a major problem with regulation is that whilst regulators are criticized when scandals occur, the costs of extra rules and controls are dispersed amongst the regulated community (and then amongst the public). Regulators will thus have an incentive to minimize the potential for scandals (and thus for criticism of their effectiveness) and so institute ever more rules and controls This problem was exacerbated by the increased power of the compliance function within organizations.

[492] A similar requirement for hard disclosure for unit trusts was introduced in 1997.
[493] Mr Nick Ansell, Chief Executive of IFA Network.

Professor Gower had warned that the FSA regime would create "...a cottage industry for compliance officers"[494], however, it is unlikely that Professor Gower could have anticipated just how much of an industry compliance would become. Compliance managers became increasingly powerful and their power-base was the rules and regulations handed down by the regulators. The problem was heightened by the fact that it was compliance managers that tended to sit on regulatory committees and it was compliance managers who tended to submit responses to regulatory discussion and consultation papers. IFA, Dr Thomas stated

> The impression many practitioners have is that compliance officers feel the need to record anything, however small, to justify their existence and salaries.[495]

Furthermore

> I found it remarkable that the PIA asserted that the rule book even if heavily pruned, will not fit into a single volume...The notion that there could be three separate volumes dealing with membership, back office and front office aspects simply demonstrates the PIA's complacent attitude to its own perceived role. Separate volumes, more self importance, greater unearned income...Without a dose of harsh reality the PIA is in danger of giving the rule book a life of its own rather than ensuring it protects consumers and guide advisers. It would be helpful if practitioners, not just compliance officers were invited to consider proposed rule changes.[496]

This pressure contributed to a regime which was more prescriptive, more costly and more complex that at any stage in its evolution. Nick Johnson[497], Compliance Manager at General Accident argued that the burden of regulation had got

> ...continuously greater, absolutely, no question...the regulation has become more prescriptive, and more detailed and more onerous and more expensive.

The final pressure, which drove the escalation of rules, was the trend of IFAs towards joining IFA networks. The concept of the IFA network was originally that of Ken

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[494] Gower (1988) *op cit.*
[495] Quoted from a submission to the PIA's Evolution Project, CP 23, 1997, Dr Philip Thomas, Thomas Financial Planning, p.7.
[496] *Ibid.*, p.6.

Davy. Ever escalating compliance costs and rising costs of providing advice combined with increasing competition to make it inevitable that there would be shrinkage in the IFA sector. Davy invented the network concept to avoid this. IFA networks work on the basis of centralizing all of the administration and management associated with thousands of individual IFAs into a central unit. In so doing, economies of scale allow significant cost savings to be made making the network member IFAs financially viable. The source of IFA networks' attraction was in their ability to reduce compliance costs for individuals. The higher compliance costs were, and the more rule changes there were, the more attractive Networks became. Dr Thomas, an IFA, wrote the following in a submission to the PIA's Evolution Project. The IFA Networks have lobbied to instigate the

> ...adoption of common administrative procedures in order to make themselves indispensable to the business process. Networks have become a license to print money and there is a danger that their influence will create an anti-competitive cartel within the financial services industry.[498]

<u>'A Beast that Feeds itself'</u>

The PIA has also exhibited various self-defensive modes of behaviour. These are consistent with those predicted of regulatory bureaucracies by Posner (1974), Niskanen (1971) and Bernstein (1955). Under fire from the media and from politicians, regulatory agencies pursue strategies aimed at maximizing their chances of survival. The prime manifestation of this form of behaviour at the PIA was the Evolution Project. This project was sold as being a fundamental review of regulatory philosophy and practice. However, the genesis of this exercise in 'regulatory re-engineering' was rather different. It was due to

- A recognition that the pensions review would not be resolved quickly; it had already dragged on since 1992.

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[497] Nick Johnson, Compliance Manager General Accident Life, interview 28th January, 1998.
[498] *Ibid.* p.2.

- A recognition that there would be a new Labour government in 1997 which was committed to reforming the regulation of investment business.

- A recognition, due to 1 and 2 above, that the PIA would be under threat/ attack from the new Government.

This project launched in 1996, with an academic Professor David Llewellyn as the symbolic figurehead. However, as a senior ex PIA director admitted in 1996 "...there was a clear political dimension to the project." The genesis of the project had been in a Board decision. They considered that it was likely that Labour would win the 1997 General Election and knew that Labour favoured a fully statutory system of regulation. The PIA had been under severe attack from the media and had been pilloried by the Treasury and Civil Service Select Committee in 1993/ 1994 and by Angela Knight for its ineffectiveness in resolving the pensions debacle. The Board thus decided to institute a whole-scale, forward looking review of regulation.

In addition to the Evolution Project, the behaviour of the PIA over the pensions review was instructive of their self-defensive behaviour. In this case it finally, after years of delay, started issuing fines and reprimands to the companies delaying the review process. However, this was the one area where the regulators were willing to fight the industry and it was because they were concerned with protecting their own interest where that was perceived to be threatened by media criticism. Gary Heath[499] put this beautifully:

> ...we have now invented a civil service [reminiscent of] the science fiction film where a chap invented a computer that not only knew how to defend itself, but also hit back whenever something tried to attack it. That's what the PIA's like now... [T]he Legal and General last week put out a paper saying, "Yes, we can do stakeholder pensions but you'll have to cut out this amount of regulation - its costing us a fortune." .... God, did they get knocked over the head by the PIA! "How dare you ruin our careers!" basically.

And as Nick Ansell argued,

[499] Gary Heath, CEO of the IFA Association, interview 8th April 1998.

> ...when you get regulators whose interest is in perpetuating their own existence, and you have rule-drafters whose interest is in safeguarding their own jobs, it becomes just a sort of beast that feeds itself...What we are out to do is the protection of the investor, not the safeguarding of bureaucrat's jobs![500]

The Evolution Project failed to fight off the threat from New Labour of instituting a statutory system. However, the ex-Chief Executive of the PIA, Collette Bowe did not suffer overly in the change. In fact, she received a Golden Goodbye package of £281,000, this elevated her earnings for the year from the PIA to over £400,000.

8. Conclusions

The origins and development of the FSA regime are text-book cases of public choice theory in action. The industry was largely able to determine what control mechanisms were put in place and was also able to determine the nature of the institutional structure that was created to enforce them. A consequence was that from an investor protection standpoint there were gaping omissions in the controls put in place. The industry, supported by the regulators of all people in the early years at least, then fought off calls for disclosure, training and competency rules and individual registration. It was only after Government, responding to media pressure, intervened that the regulators actually supported the interests of the investor. Even then there were question marks over the way in which the rules were implemented and enforced.

The behaviour of the regulators in their handling of the pensions review is indicative of the way in which policy-makers chose to serve their private interests rather than the interests of the investor. The behaviour of the regulators and the development of the FSA throughout the ten year period from A-Day in 1988 is incomprehensible from a public interest theory perspective. There is no plausible rationale, from an investor welfare perspective, for hard disclosure, training and competence, individual registration and consumer education *not* to be key regulatory instruments in achieving the goal of investor protection. Moreover, it is implausible that a regulatory body whose raison d'être is to protect investors would join the industry in opposing such measures.

[500] Nick Ansell, CEO of IFA Network, interview 19th March, 1998

It is only when the public choice explanation is considered that the behaviour of the regulators becomes comprehensible. The regulators and the industry pursued their private interests. The initial regime, being fundamentally influenced by the industry was utterly flawed both in the institutional structures it established, in terms of the control mechanisms put in place and in terms of its articulation (or failure thereof) of the goals of regulation. The regime's development was profoundly influenced by the industry, the regulators were themselves dominated by practitioners and in practice chose to serve the interests of practitioners rather than consumers.

CHAPTER SIX

Failure to Enforce, Mis-selling and Scandals

1. Introduction

The previous chapter explored the way in which the regime put in place by the FSA was flawed due to the manner of its construction. The initial impetus for the process which ultimately led to the FSA was inherently political. It was based on efforts to deflect criticism that the Government was soft on 'White-collar' crime and also to increase the confidence of the public in the investment industry. However, the rules, control mechanisms and the institutional structure put in place were in fact designed, in a fundamental sense by the industry, with the interests of the industry rather than the investor at heart. In consequence, control mechanisms that were essential for investor protection were conspicuously lacking from the initial regime, and the merits of some central pillars of the regime were unclear.

This chapter explores the ineffectiveness of the FSA regime in protecting the investor. I contend that the failure of the FSA regime to serve the investor in the early days was because the regulators were captured by industry interests. The regime failed investors in various ways: (i) it failed to enforce some of the rules; (ii) it failed to a large degree to protect the investor from mis-selling and financial scandals; (iii) it failed – largely - to prosecute criminal mis-selling; (iv) on the whole it failed to compensate victims of mis-selling especially in the pensions review; and (v) it failed to tackle the many products that, due to very high charges, offered poor value to investors.

It is acknowledged (as in the previous chapter) that the regulators became, on the whole, more effective towards the latter years of the FSA and the evidence of regulatory failure will thus come primarily from the early years of the FSA's operation.

2. The Failure to Achieve Compliance

In an article in the Times in 1990 it was argued that "...while members of the financial services industry are still operating freely, it appears that they are often doing so without regard to the rules of their SROs..."[501] In fact, there is widespread evidence that the regulators failed to achieve any reasonable degree of compliance with certain key regulatory rules; and in particular the rules on best advice, suitability, on record keeping and in terms of training requirements. The failure of the regulators to achieve any reasonable degree of compliance with these rules, not only had devastating consequences for the investor, but was also a prime indication of their sympathy for powerful industry interests.

Interview testimony from senior industry executives not only supports documentary evidence[502] on widespread non-compliance with key rules, but also suggests that: (i) non-compliance was widespread from day-one; (ii) there was widespread awareness of the non-compliance, including by the regulators; and (iii) the regulators, initially at least, did very little to tackle it.

Evidence of the Failure to Achieve Compliance with the Rules

The most powerful evidence of non-compliance relates to failures of many firms to collect sufficient information to be able to justify that the advice given was best advice. Such non-compliance ranged from failures to complete fact-finds on clients, to the invention of fact-find details on investors to support a sale. There is also some evidence of cheating on competency exams when they were finally introduced.

Record Keeping and Best Advice

The audit trail is a key feature of the FSA regime. Firms are required to both complete detailed research on clients before selling to them (the Fact-Find process), and also keep detailed records that would in principle, allow ex-post judgements to be made as to whether best advice has been given. Specifically the requirements were:

SIB Principle 4: A firm should seek from customers it advises or for whom it exercises discretion any information about their circumstances and investment objectives which might reasonably be expected to be relevant in enabling it to fulfil its responsibilities to them.

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[501] The Times, "Streamlining to build muscle into the SIB", David Pine, 14 June, 1990.
[502] Such as in the KPMG report of 1993.

SIB Principle 5: A firm should take reasonable steps to give a customer it advises, in a comprehensive way, any information needed to enable him to make a balanced and informed decision. A firm should similarly be ready to provide a customer with a full and fair account of the fulfilment of its responsibilities to him.

However, there is evidence of non-compliance with the requirement to complete the paper-work before selling investment products. A former Colonial Mutual salesman, Maurice Timbrell alleges that,

> I never fully completed a Factfind at the client's home because it seemed to be a common practice to fill in the missing details on return to the office. Everyone was doing it. The attitude was "Get the business! Fill in the paper work when you get back to the office." Factfinds were being manipulated to suit the sale you wanted. If you wanted a big sale then write the Factfind to make that look like Best Advice. It was more commission for us...' One of his former colleagues commented that 'These [Factfinds] were little more than a waste of time to some of the "old hands" who worked the system to suit themselves. [503]

Another ex-CMG employee, Roger Snell alleged that "although he properly filled in Factfinds with the client he witnessed others taking them incomplete to the office. 'They were making the client fit the policy they wanted to sell'."[504] Another Colonial Mutual adviser, Mark Hayes said that he was "worried about qualified financial advisers not filling in Factfinds properly...He states that he had seen a signature 'copied' onto a Factfind to save a return visit to the client. He also claims that one manager asked him to impersonate a client over the phone in order to get some necessary information for a gap in a Factfind."[505] This evidence supports the testimony of IFA and ex-Midland Bank employee Steve French[506] argued along similar lines,

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[503] *The Whistle*, 1996, "Colonial Mutual; The Failure of Self-Regulation" p. 16.
[504] *Ibid.* p.15.
[505] *Ibid.* Other evidence from the Whistle research was equally powerful. Another employee, Javier de Mijangos alleged that "The completing of fact-finds was as follows: The general information was entered on the Factfind during the appointment. However, the rest was ALWAYS completed back at the branch." Another ex-employee, Derick Woods, alleged that on one day, the 1st of June 1994, "three fact-finds were fiddled to satisfy compliance."
[506] Steve French, IFA with Accountants Haynes-Watts, interview 15th May, 1998.

> Well, I personally always conformed to the proper rules ... but some people would just fill facts and figures in! ... I've seen it throughout my life, and even with very, very reputable companies. ... I would phone someone up and it would be on the fact-find that they'd made a will, that they get X amount of earnings, that they had a house, and so on, and then when you chased them up, it turned out they'd got nothing. No will, no house, no job, nothing. ... Its still happening. ... Its got to the stage where I write on the fact-facts that another so-and-so has made it all up.

The failure to comply with record-keeping requirements first became widely apparent from evidence presented in a KPMG report published in December 1993. This report examined the sales of personal pensions over the period January 1991 to June 1993,[507] and produced a number of disturbing findings:

- In 91% of the cases studied, life assurance salesmen and other financial advisers had collected insufficient information about their clients to justify the advice they had given to transfer to personal pensions. The legal obligation to comply with the 'best advice' requirement was thus apparently ignored in the vast majority of cases. In addition, in a substantial number of these cases the advice given was believed to be suspect, and not merely unsatisfactory.

- Some 89% of cases involving FIMBRA members, 95% of those involving LAUTRO members, and 89% of those involving IMRO members failed to meet compliance standards.

- Even after getting guidance from SROs, the proportion of cases where insufficient information was on file fell from 88% to 69% (i.e., so the regulators managed a 31% success rate in enforcing their own rules on record-keeping!).

- Following guidance from the SROs and the proportion of cases of suspect advice fell from 39% to 33%.

[507] And therefore did not cover the period when most abuses seem to have taken place.

Although the KPMG report was widely (and predictably) criticized by sectors of the industry, especially given that as an accountancy firm KPMG is a direct competitor of the IFAs and other advisers it was reporting on (and being so critical of), its results were nonetheless alarming. As Phil Telford[508] of the Consumers' Association aptly commented, "No one could produce decent files. [It was] quite appalling."

Training and Competency of Salesmen

There were only very minimal requirements in the SIB rules as far as the competency of salesmen and advisers selling investment products to the general public was concerned. Before the deadline for passing the FPC3 in July 1997, the only requirement was an extremely vague one articulated in SIB principle 9:

> A firm should organise and control its internal affairs in a responsible manner, keeping proper records, and where the firm employs its own staff or is responsible for the conduct of investment business by others, should have adequate arrangements to ensure that they are suitable, adequately trained and properly supervised and that it has well-defined compliance procedures.

However, there is some evidence of breaches of the rules on training and competency, particularly related to the Colonial Mutual insurance company which was investigated by Freedom to Care in 1996. CMG is significant in the UK as being one of the principal advisers to the state superannuation schemes for teachers, prison workers, nurses and so forth. CMG's largest customer is the teaching union, the NASUWT. However, the evidence presented by Freedom to Care, documents cases of supervised visits being invented and of employees being allowed (and even encouraged) to cheat on their exams. Whilst this single case can in no way be taken to be universal practice, it is significant as an example of what was happening in a major financial institution at the time.

One ex-Colonial Mutual employee alleged that,

> The licensing exam was a joke. You learned your stuff from a computer programme and then you were supposed to take a multiple choice test from the programme. But people were going

[508] Phil Telford, Senior Researcher with the Consumers' Association, interview 11th February 1997.

in and out of the room, and the branch manager would look over your shoulder and if he saw you putting a finger on the wrong answer he would tell you the right one. Everyone was doing it.[509]

Another former employee of CMG alleged that "After the final exam at training I had to re-sit the test at Gatwick. I was given a paper to copy the answers from. This paper was the work of an experienced rep called Ian Harris. These instructions were given by [manager] Ian Douglas."[510] Another ex-employee, Maurice Timbrell alleged that the official records which supposedly confirmed that he had complied with the rules on the number of supervised visits that new salesmen must make, had been falsified. The official records of his 'on-the-job' training indicated that he had made supervised sales-visits on days when he was on fishing trips, sitting exams or in the office.[511] Brian Grant, ex of the CMG Wolverhampton branch[512] alleged that "Regarding training records. These were in some cases filled in and put on my file when there was a visit by LAUTRO or compliance officers, and not when they had been done or allegedly done."[513]

Even in more recent times, there is anecdotal evidence of cheating in exams. For example, ex-Prudential salesman, Peter Parkinson alleged to the Times in May 1999[514] that "staff often cheated when they took their Prudential exams".[515] Whilst some cheating in exams is inevitable, and it is undoubtedly true that many, indeed most people probably didn't cheat, the evidence on cheating by some and more importantly on the apparent complicity of their managers in the cheating is worrying.

Evidence of a Culture of Non-Compliance

[509] *Op. cit.,* p. 13.
[510] Ibid.
[511] Ibid.
[512] Between January 1994 and July 1994.
[513] Op. cit., p.11.
[514] *The Sunday Times*, 30th May, 1999. "Man from Pru sues over sales tactics", Nick Gardner.
[515] There is also evidence of people giving financial advice in contravention of rules of authorization. As the Parliamentary inquiry discovered in 1993/ 94, sales consultants were selling complex investment products after very little training, with no supervision and were getting senior staff to sign their sales off. "Rowab Ullah has been a Consultant since 2 September 1988. He sat two exams on 16 September 1988 and 9 March 1989, both of which he failed. He has sat no exams since March 1989...Despite the fact that he has never passed any exams with us he has continued selling for over two years. He has submitted over thirty cases this year producing commissions of around £80,000. All his case submission sheets have been signed and authorised by the Branch Manager, Derek Thomas, whose National insurance number has been input for license checking purposes." (Treasury and Civil Service Committee Inquiry, *Minutes of Evidence*, 27 April 1994, p.292).

Even more serious than the anecdotal examples of serious non-compliance in financial services organizations is the evidence that a culture of non-compliance existed within some organisations, and that this culture emanated directly from the boardroom. Laurie Edmans[516], a senior industry executive, was extremely frank about attitudes within the industry towards legislation and regulation:

> I'd never seen so many sleazy backrooms in my life - it was grievous. I remember one guy, saying to me a few months before the FSA was due to come into force. "What Financial Services Act?" and so I briefly explained to him about the Act and about compliance. He said, "Oh yes. *You* can do all that stuff. I can tell you that once my salesmen are in the front room with the punter, they will say anything to get them to sign. And it doesn't matter what the law says!" This attitude was extreme, but ... it was not unusual.

This attitude towards compliance was perhaps best personified by the Prudential. The Prudential is the UK's largest insurance company[517] by far and yet there is evidence that it ignored key rules for years. The Pru had by far the largest individual share of pensions mis-selling cases (10%) and its conduct in the pensions review finally earned it an unprecedented formal public rebuke from the SIB (now increasingly willing to show its teeth) in September 1997. This was soon followed by an even stronger public statement in December 1997 by the newly formed and more assertive Financial Services Authority.

The earlier statement by SIB in 1997 centred on the failure of the Prudential to meet targets for the pensions review. The firm initially maintained that it had done nothing wrong and had never mis-sold any personal pensions. It continued with the same line even after LAUTRO had investigated it and found evidence of bad practice. Its chief executive, Mick Newmarch, then blatantly defied the regulators and refused to set aside any funds for possible compensation purposes. However, some 41,000-plus cases were subsequently identified as being in need of urgent resolution - not to mention the many thousands of other cases the regulators, though presumably not the clients concerned, regarded as 'non-urgent' - and Mr. Newmarch was eventually forced to resign. Four months later, only ten (or less than 0.025 percent!) of these 'urgent' cases had been resolved. Having given a succession of assurances on the

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[516] Laurie Edmans, Deputy CEO, NPI, Interview 27th February 1998.

[517] The Prudential manages £119 billion for ten million customers across the world.

completion of 90% of phase one cases – and missed them all, SIB concluded in its public statement in October 1997 that the failure reflected "...serious shortcomings in its conduct of the pensions review." Moreover, that the Prudential had failed to "...exercise the requisite due skill, care and diligence required of it..."[518]

An inspection visit undertaken by the new Financial Services Authority in 1997 confirmed that the firm had done little to put its house in order. The FSA subsequently reported that the firm had "failed to implement adequately the requisite corrective action in respect of earlier breaches of the regulations", and found "continuing persistent and serious breaches across major areas of its business". Among other shortcomings, the FSA also reported a "deep seated and long standing failure in management" which prevented the firm recognizing its own shortcomings, and as well as major compliance problems, most particularly, what the FSA euphemistically described as a "cultural disposition against compliance" which permeated the whole firm.[519]

The extent of non-compliance with certain key rules makes it unlikely that the regulators didn't know what was happening. Indeed, as far as malpractice was concerned even Mark Boleat[520], speaking as the Head of the ABI, the main trade association for the life officers, accepted that knowledge of bad-practice was widespread:

> Everybody knew what was going on in the late 1980s. I came across it myself. We all knew that life assurance salesmen were bloody awful people, who were to be avoided at all costs. The regulators knew it was happening...

Barbara Saunders[521], Chair of the PIA Consumer Panel had similar recollections:

> LAUTRO must have realized, at the time, that there was an issue there. And you have to say, 'why didn't they hit it on the head?' I mean you only had to be an ordinary member of the public, after Maxwell, to see financial advisers outside every government building,

[518] SIB Press Release (1997), "The Securities and Investment Board Public Statement", October 21.
[519] The FSA quotes are all taken from its press release on Prudential Assurance, dated December 16th, 1997.
[520] Mark Boleat, Director General of the Association of British Insurers, interview 26th November 1997.
[521] Barbara Saunders, Chair of the PIA Consumer Panel, interview 31st March 1998.

outside every railway station, I mean tackling people coming off trains! So I mean, you know. And that's I suppose one of my first recollections of what subsequently became the pensions mis-selling debacle, to see financial salesmen, everywhere! There is no doubt that people knew what was happening but there was nobody there to put it right and, well, if there was we certainly weren't aware of it.

Senior management have always claimed that it is very difficult for them to control their sales staff, especially in terms of paper-work and general administration. Laurie Edmans[522], Deputy Chief Executive of NPI argues that,

> the big problem ... was that what was going on out there with the end customer was very, very different from what the people who sat in the boardrooms thought was happening. I mean these organisations are populated by actuaries and very worthy people who all knew each other in the City and so on ...., but had no idea how their policies translated through to sleazy brokers in somewhere like Dagenham saying anything that came into their mind to get the customer to sign. They just didn't know what was happening.

This sort of argument is rather unpersuasive. Controlling sales staff is not easy, but that is exactly what senior management are paid so much to do. However, the real issue, more often, is that senior management did not want to know what was going on because they already had a very good idea

An ex-Midland bank salesman Robert Reaney, now an IFA, expressed the following concerns,

> Now who do you blame? You could blame the regulator, because the regulator should have been stronger, you could blame the companies, because the companies should have taken a stronger view themselves? And so, the poor chap that gets hit, is the little adviser or rep or whatever, who's just trying to earn his corn, and make a living and doing as he's told. Because at the end of the day you go to work, you have a manager, if the manager says 'This is what you do', you believe him! You do that and then you find five years, ten years later that you shouldn't have done that. Who's to blame? It's a good question.

Ultimately, it was senior management who instilled the culture of sales-maximization, and it was the senior managers who benefited (at least in the short

[522] Laurie Edmans, Deputy CEO, NPI, Interview 27th February 1998.

term) from achieving and in many cases exceeding their sales-targets. In many cases, it seems that management knew what was happening, but it paid not to ask. Not asking also gave management what they thought was plausible deniability. The industry was not afraid of the regulators (because they were *de facto* trade associations) and so simply ignored the rules that they didn't like. As Gary Heath[523] confessed in 1998,

> at the moment [the industry} is... still not scared enough of the regulators to worry about them too much. That's the balance of it. They'll say all sorts of things in public, but that's the reality of it. And even now there are some companies who are out there mis-advising, with management's knowing perfectly well that's what's going on. They don't give a damn.

The evidence on the extent of non-compliance supports this view, as does the evidence on the increase in fraud and malpractice after the FSA came into force.

Why did capture lead to non-enforcement of the rules?

The failure of the FSA regulators, in the early days, to realize any reasonable level of compliance with pivotal rules is perplexing. However, it must be recalled that the original impetus for reviewing the regulation of investment business was political. The Government was attempting to quell criticism in the media for being soft on its friends in the City after a series of minor but highly public scandals in the early 1980s. Regulation was thus thrust upon both the Government, and ultimately the industry. Even though the industry was successful in influencing the rules that were put in place and on the nature of the institutional structure put in place to enforce the rules, it should not be doubted that there were also rules for which the industry had little but contempt. The requirements for record keeping, the controls on the selling process and the rules on best advice were, as far as many people in the industry were concerned onerous, costly and undesirable.

A number of industry executives were extremely cynical about the requirements to give best advice and to 'know your customer'. Mark Boleat[524] said

[523] Gary Heath, CEO of the IFA Association, interview 24th November 1997.
[524] Mark Boleat, Director General of the Association of British Insurers, interview 26th November 1997.

that "The concept of 'Best Advice' is ludicrous, it is just so absurd, how any sane person could come up with it is a mystery." Nick Johnson of General Accident expressed similar sentiments stating, "I think that phrases like 'best advice' are probably not helpful."

And Joanne Hindle further recounted,

> I can remember going around lecturing on compliance with the FSA back in 1985 or 1986 before the Act came in. And I was saying 'You'll be required to know your customer'. Almost being booed off the stage - the idea that they'd have to prove that they knew something 'I've dealt with this family for thirty years, of course I know all about them.' Well fine, just write it down! 'Why should I have to prove that I know this, of course I know she's got a grandson.' Just write it down. And of course a lot of them didn't really know, they'd just phone them up and say 'Yes, we'll fix that up for you'...The concept of...'know your customer'... was greeted with horror in some quarters.

Prescriptive rules on record keeping, paper-work and so forth imposed costs and increased the time it took to sell products. It might therefore be hypothesized that the capture of the regulators might lead to a failure of enforcement of the rules that might have these effects. In fact, this is precisely what is found.

This line of reasoning is supported by evidence that those rules substantively constructed by industry interests *were* enforced by the regulators. The rules on polarization, the MCA (whilst it lasted), authorization and disclosure were all enforced. Indeed, the vigour with which FIMBRA, LAUTRO and the PIA enforced the rules on polarization - to the extent of producing detailed prescriptions on the wordings on business cards - was commented on by many industry respondents.

Nick Johnson[525], of General Accident observed that

> in 1988...the regulators were focusing on disclosure wordings, and things on business cards that no body understands today...all to do with polarization of course... If they'd abandoned all that nonsense...I think that some of the problems we've experienced in the last 7 or 8 years probably wouldn't have arisen or would have been smaller.

[525] Nick Johnson, Compliance Manager General Accident Life, interview 28th January, 1998.

Ultimately, the failure of the regulators to achieve any reasonable degree of compliance with the pivotal (as far as investor protection is concerned) regulatory requirements leads to one or both of two conclusions: either the regulators have been grossly negligent or they have chosen not to enforce the rules. Given the lack of any reason to doubt the competency of regulatory staff, the latter explanation – that the regulators chose not to enforce the rules – remains. However, perhaps the failure to enforce such onerous record keeping rules is also understandable from a public choice perspective. For, as was shown in the preceding chapter, the regulators (certainly in the case of LAUTRO and FIMBRA) were trade associations who *de facto* existed to serve the interests of their members. It was not in the interests of their members to follow the rules on record- keeping and so they didn't, and the regulators didn't make them.

3. Mis-selling Scandals and Regulatory Failure

The supposed primary public interest objective of the FSA was to protect the ordinary investor. As the first Chairman of the SIB, Sir Kenneth Berrill argued in 1988 the aim of the FSA was to protect investors not merely from out-right fraud but also "...from [the] millions of cases of apparently minor malpractice – hidden charges, conflicts of interest leading to preference of firm over client, bad advice given through over-optimism, under-research, straightforward incompetence."[526]

Although Professor Gower, the architect of the FSA never claimed that regulation would prevent financial fraud and malpractice ('scandals') in their entirety, it is reasonable to assume that one of the effects of imposing a major investor protection regulatory regime would be that they would at least be reduced. Although it is clear that we can never know how many scandals would have occurred in the absence of something like the FSA, the fact is that a succession of financial 'scandals' did occur under it, and, moreover that there is some evidence that levels of mis-selling actually increased under the FSA. The most serious example of malpractice and criminal mis-selling was in connection to the mis-selling of several million personal pensions between 1988 and 1994. There is also evidence of mis-selling of other

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[526] Berrill, K. (1987), *op. cit*, p.2.

products, including endowment mortgages, home-income plans, guaranteed income bonds and Free Standing AVCs.

As the Consumers' Association argued in their submission to the Select Committee Inquiry in 1994,

> The existing requirements – to know the customer's requirements and objectives, to recommend suitable products only, and to give Best Advice – *should* give a high degree of investor protection. However, the regulations have clearly been consistently and extensively flouted by all sectors of the industry.[527]

Early Lapses of Life and Pensions Products

The first evidence on mis-selling comes from the lapse rates of investment policies. Pensions and life assurance policies are designed as long term investments. However, the commissions on these policies are front-end loaded, which is disastrous to the investor if the policy is terminated early.[528] Consumers' Association research conducted in 1992 found that of forty low-cost endowment policies considered, only one had a higher surrender value than the premiums paid in after five years. After two years, the surrender value was either nil or considerably less than the premiums paid in.[529] However, research conducted by AKG in 1993 found very low levels for expectations of policy duration, ranging for the direct sales side from 5.7 years for a linked life policy to 8.6 years for a non-linked life policy.

The extent to which early termination is an indicator of mis-selling is contentious. Quantitative research conducted in 1992 by the Watford group of life companies produced the following results[530]:

In a survey of 7,500 customers whose policies had recently lapsed early,

- 68% said they had lapsed due to a change in personal circumstances;
- 17% said they had lapsed due to product cover/ value for money issues; and

[527] Treasury and Civil Service Select Committee (1993-1994), "Financial Services Regulation: The Consumers' Association", Wednesday 23 February 1994, p.45.
[528] It has been argued, especially by the Consumers' Association that front-end loading of commissions is more to do with the desire of the sellers of investment products wanting to transfer the risk of early termination almost wholly onto the investor.
[529] WHICH?, "Saving Through Life Insurance", September 1992, p.512.
[530] 'Persistency Research', conducted by Survey Research Associates, July 1992.

- 14% said they had lapsed as a result of bad advice or service problems.

The crux of the argument thus becomes, to what extent are lapses - which are the result of changes in personal circumstances – the fault of the adviser or of the investor. It has been argued that early lapses which are the result of changes in personal circumstances are the sole responsibility of the investor. However, this is an unpersuasive argument given the requirements to conduct a Factfind and to give Best Advice. As the Consumers' Association argued,

> ...in many cases, professional judgement plus a satisfactory fact-finding procedure could have led the seller to conclude that there was a significant risk of such a change [in circumstances].

Evidence from AKG indicates that there is a considerable variation in the lapse rates between different providers for the same product. If product lapses were principally explainable by exogenous factors, such as recession, then it would be expected that there would be a small variance between the lapse rates for different providers. However, the variances in persistency levels for the same product between different providers is enormous. AKG found that the average number of policies lapsed after three years ranged from 25 per cent to 60 percent. It is difficult to explain such as huge variance by exogenous factors alone.

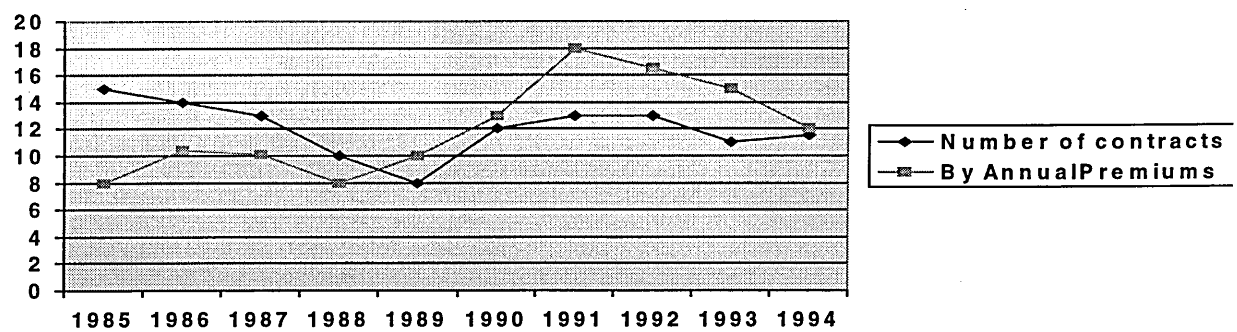
Table 2. Termination of life and pension products sold by company representatives[531]

		AFTER ONE YEAR	AFTER TWO YEARS	AFTER THREE YEARS
Whole of Life	1993	15%	25.1%	33.3%
	1994	14%	23.4%	
	1995	12.1%		
Personal Pension	1993	15.9%	27.6%	36.3%
	1994	16.1%	17%	
	1995	14.5%		

531 Third Survey of the Persistency of Life and Pensions Products (1997) The Personal Investment Authority, London.

The costs of early termination to the investor is enormous. AKG Ltd. estimated that the costs to the investor of termination in the first year alone amounted to £300m.[532] The evidence suggests that there was a considerable increase in early-terminations after the FSA came into force. Lapse rates[533] fell from 11% in 1985 to 8% in 1988, but then rose dramatically after the FSA came into force to a level of 18% in 1991.[534] Although lapse rates have fallen in more recent times, they still remain above the levels seen in 1985. The PIA data also indicate that lapse rates for life and pensions products have been high in the FSA period and still remain high. For example, approximately a third of policies sold by company representatives in 1993 were terminated within three years. The costs of these early terminations to investors were enormous. In an OFT report published in June 1994, it was estimated that 60% of life policies in force were likely to be cashed in early with derisory or negative returns.

Figure 6. Persistency rates of Life and Pensions Policies[535]



As Harriet Hall[536] of the National Consumer Council argued:

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[532] Consumers' Association, Evidence presented to the Treasury and Civil Service Committee Inquiry into Financial Services Regulation. Session 1993-1994. Wednesday 23 February 1994, p.45.
[533] As measured by the ratio of annual forfeitures to new business.
[534] Simpson, D. (1996), p. 39.
[535] Simpson, D. (1996), *op. cit.*
[536] Harriet Hall, The National Consumer Council, interview 11th February 1998.

If you look at life assurance figures, the number of life assurance policies that are surrendered within the first three years is still enormous, and they are obviously being sold to people who oughtn't to be buying them – if it were at sort of 1% or even 5%, you'd reckon that's probably within the level of people who every year become unexpectedly unemployed. But with levels of 15 up to 20%, there are a lot of people who are still being sold who could never afford it in the first place.

Although few would doubt that the rules introduced in the later years of the FSA delivered many benefits and probably prevented much mis-selling, it is still the case that recent PIA data (illustrated below) on early terminations indicate that there remains a startlingly high level of early termination of life policies.

Table 3. Lapse Rates of Regular Premium Life Policies[537]

		AFTER ONE YEAR	AFTER TWO YEARS	AFTER THREE YEARS	AFTER FOUR YEARS
Regular Premium Policies: all sales channels	1993	11.2%	7.7%	6.3%	5.0%
	1994	10.8%	7.4%	6.2%	
	1995	10.1%	7.7%		
	1996	9.2%			

Table 4. Lapse Rates of Regular Premium Life Policies[538]

		AFTER ONE YEAR	AFTER TWO YEARS	AFTER THREE YEARS	AFTER FOUR YEARS
Regular Premium Policies: Home Service	1993	15.2%	8.9%	7.0%	4.9%
	1994	13.9%	8.8%	6.6%	
	1995	13.4%	8.6%		
	1996	12.4%			

[537] The PIA, "Life Assurance Disclosure", (February, 1999), (London: The Personal Investment Authority). The heavily shaded figures refer to policies still in force.
[538] Ibid.

The continued extent of product lapses within the first year is indicative of a high level of inappropriate advice.

The Mis-selling of Endowment Mortgages

The second incidence of mis-selling involves the sale of mortgages and widespread evidence of commission bias. Endowment mortgages are policies where the borrower does not repay the mortgage loan until the end of the mortgage term. Instead, the monthly premiums are invested into one of the insurance company's endowment policies. In theory, upon maturity, the endowment is then used to pay off the mortgage loan and provide (hopefully) a surplus.

However, there are two practical problems with the endowment mortgage. The first is that the level at which the monthly premiums are set is based on the insurance company's assumptions of expected investment returns, allowing for the effect of charges. If these assumptions about growth rates or charges prove to be unrealistic, then the investor can face a short-fall. In practice, the use of overly ambitious anticipated growth rates and, in some cases the understatement of the effect of charges has meant that many investors have been forced to increase their monthly premiums. Indeed in some cases, the projected growth rates were so unrealistic that policy-holders have been confronted with having increase their monthly premiums by very considerable amounts. For instance, if someone had taken out a low-cost with-profits endowment policy with Pearl Assurance in 1993, they would be faced with having to increase premiums by 33%; and this after only five years of the policy's term.[539]

A second problem relates to surrender values. Endowment mortgages, due to front end loading of commissions and charges, attract punitive penalties for early termination. If the policy is lapsed in the early to middle years then returns can be less than from a basic savings account; in the worst case returns can even be negative

[539] The Consumers' Association, "The End For Endowment Mortgages", *WHICH?,* August, 1998.

Table 5. Ten Year Surrender Values.[540]

LOW-COST WITH-PROFITS ENDOWMENTS: SURRENDER VALUES (policies taken out in 1988)			
Company	Premiums Paid	Surrender Value	Average Growth PA
Commercial Union	7,581	7,304	-0.7
Ecclesiastical	9,291	9,853	1.2
Friends Provident	7,524	8,290	1.9
Pearl Assurance	8,242	9,805	3.4
Prudential	8,060	10,126	3.5
Royal Life	7,741	7,913	0.4

The low surrender values of endowment mortgages are not necessarily a problem *if* the policies are kept to term. However, the fact is that most people who buy endowment policies do not keep them to term. In fact, the average term of endowment policies is a mere seven years. For this reason, consumerists have long recommended that house-buyers use the alternative to the endowment mortgage, namely the repayment mortgage.

Despite their disadvantages, it is the endowment mortgage which has dominated the mortgage market over the 1980s and early 1990s.[541]

It has been argued by some that the dominance of the endowment mortgage is due to the fact that they provide the salesman with quite considerable commission payments. Indeed as the National Consumer Council's Harriet Hall stated,

> I was talking to [someone at] the Council of Mortgage Lenders about the [Mortgage] Code...And he then told me that if they recommend an endowment mortgage, they're likely to earn £700 - £800, but if it's a straight repayment they are likely to get £30 - £40.

In fact, the financial incentive for selling the endowment in preference to the repayment mortgage suggests that the motive of earning commissions, rather than serving the investor's best interests, has driven the growth of the market under the FSA. Phil Telford[542] commented that:

[540] Op. Cit.
[541] In 1988 the endowment mortgage accounted for 83% of the mortgage market. The dominance of the endowment mortgage declined over the late 1980s and early 1990s, but remained almost three times as important as the repayment mortgage even by 1993.
[542] Phil Telford, Senior Researcher with the Consumers' Associaton, interview 9th June 1998.

> Endowment mortgages have been sold traditionally because they paid such high rates of commission to advisers. Clients didn't know very much about whether they were the right thing or the wrong thing, so they could fairly easily be sold, you know.

The mortgage market has always been open to sharp practice, as Laurie Edmans[543] recalled,

> ...it was quite common practice in those days [the 1980s] that if someone came and they wanted to move (which people do typically after seven years) then the quotes 'advice given' closed quotes, will be... 'Well I see when you took out your mortgage seven years ago you took out an endowment policy, that will have acquired quite a decent surrender value by now. If you surrender that policy now, you can use that money to buy yourself the curtains and the carpets in your new place, and all you have to do now is to start off another one which has got the same premium. So you're not going to be any worse off any month.' And that was quite common place.

In this case investors lost out considerably by terminating the policy early but the salesman earned a substantial commission by selling a new product. This practice of churning continues to occur as salesman face an increasingly saturated market; this is despite it being supposedly outlawed by the Act.

The Mis-Selling of Personal Pensions

Background to the Pensions Scandal

The biggest and most serious scandal involved the mis-selling of several million - the exact number is still not clear - of personal pensions in the first five years of the FSA regime. The Government created the personal pension scheme in 1988 and the underlying idea – a reasonable one in itself - was to give individuals more control over their own pension provisions. The Government also hoped that the availability of personal pensions would alleviate the growing problem of unfunded pension liabilities and its potentially disastrous implications for public finances in the decades ahead. The Government therefore encouraged the adoption of personal pensions by giving them certain tax advantages and by funding a heavy £1.2 million advertising campaign to encourage individuals to buy them. Tony Newton, one of Norman

[543] Laurie Edmans, Deputy CEO, NPI, Interview 27th February 1998.

Fowler's team at the D.S.S. even stated that "Everybody in his right mind should have one".

A vast new - heavily subsidized - market thus opened up, and the industry lost little time taking advantage of it[544]. With potentially enormous profits at stake, the industry mounted a huge sales drive and, over the next seven years, persuaded about eight million people to buy personal pensions.

Evidence of Fraud and Malpractice

In the process of selling personal pensions, many firms operated with remarkable disregard for ethical or legal considerations[545]. For example, it is now known that sales staff in many firms were often told to focus on new sales and not worry about the paperwork. It was often implicitly assumed that audit trails and other regulatory compliance requirements were not particularly important, although few people would actually say so openly, and the regulators themselves did relatively little to discourage such attitudes or ensure that firms' management took their obligations seriously – perhaps this was partly because it was the government itself which had started the selling frenzy. In the early years of the FSA, selling practices degenerated, and stories abound of unscrupulous practices:

- One common technique was to hire new sales staff, start them off by encouraging them to target their family and friends, and then fire them when the contracts were in.

- Another common technique was to persuade people in lucrative state pension schemes (such as miners, teachers and nurses) to either opt out of these schemes and take out a personal pension or to transfer the benefits from their state schemes

[544] The scale of the selling was enormous. In 1989 for example, nearly 3.4 million people contracted out of SERPS to a personal pension and a total of 58,000 miners, 32,000 nurses, 27,000 teachers and 23,000 steelworkers opted out of their lucrative occupational schemes to take out personal schemes.

[545] The World In Action program, "Unhappy Returns" in 1997, presented astonishing footage (taken with a hidden camera) of financial advisers from all of the major High Street institutions giving advice in blatant violation of regulatory rules on suitability, on the requirement to go through a fact-find and, in some cases on basic criminal law rules on mis-representation, negligence and fraud. Several of the advisers blatantly ignored repeated protestations from the client that she had a very insecure financial future (she said that she was coming towards the end of a contract that may not be renewed) and was also thinking of starting a family. Regardless of this, all advisers went through with the sale of a personal pension.

into a personal scheme. A whole manner of highly unethical sales practices was employed ranging from omitting to comment on the benefits of the state scheme to blatant fraud. Many elderly miners, made redundant in the late 1980s, were persuaded to invest their state pension 'pot' into a personal pension, when anyone but a fool could have known that they would never work again and thus required income. The net result was that the investors paid huge amounts in commission and often made large losses on their investments.

- Another practice was the sale of the so called 'television policy', where salesmen would target the elderly by persuading them to cash-in their investment policies (most often policies provided by home service companies) and use the surrender value to buy a new television and video recorder. The adviser would then suggest that they should start up a new policy, for which the adviser would earn a substantial commission.

Many firms also resorted to clearly illegal practices of one sort or another, and stories abound of salespeople misrepresenting the options put to clients, doctoring paperwork to misrepresent their discussions with clients, and ignoring the legal requirement to provide 'best advice'. Compliance with regulatory requirements was minimal.

The worst single example of practice verging on criminal fraud was recounted by an IFA:

> I mean to give you an instance...basically he [a salesman] set up a PO box... [and advertized] 'builders wanted and miners preferably...' [He got] loads of inquiries, then goes out and sees them and sorts all the business out! You know, he does it from a third party sort of view, the building firm is his brother's or his cousin's, and he's the financial adviser who happens to be in the area knocking on all the doors like everyone else was. Plenty of names to go at, thank you very much. And he had a very, very wealthy year.

The pressure intensified as the market became saturated and sales became harder. One participant later said that:

> the atmosphere in some sales teams could be best described as Wild West mixed in with eastern bazaar. Although product sales were still strong, the market was beginning to

> become saturated and the first signs of the early 1990s recession were starting to make selling conditions tougher. Sales people were put under increasing pressure and by a range of incentives, some of them fairly obvious, such as bottles of whisky and holidays in the Bahamas. ... Bizarre punishments were also devised for those who had done badly.... This culture was made the more frenetic by a rapid ebb and flow of sales people. One authoritative estimate puts the annual turnover of sales representatives in the early 1990s at nearly 60%, compared with 30-40% in more normal times.[546]

Not surprisingly, evidence of mis-selling and other bad practice gradually became public, and the industry was soon in receipt of some very bad publicity. As the *Economist* ruefully observed in December 1993, "The British have come to regard life-insurance salesmen with the deepest disdain. They may be too generous..."[547]

Evidence on the Extent of Pensions Mis-selling

The situation degenerated to such an extent that even the regulators could ignore it no longer.[548] By 1993 SIB was finally forced to respond to the growing weight of anecdotal evidence on widespread mis-selling of personal pensions.

The KPMG Evidence

A report, commissioned by SIB, was published in December 1993 and was focused on 735 examples of pension transfers. Although some care should be taken when reading the report – afterall, KPMG is an accountancy firm and thus a direct competitor to IFAs and tied agents for giving investment advice - the report's findings were nonetheless powerful. It concluded that there was "...prima facie evidence of widespread regulatory compliance failure."[549] The overall results showed that a mere 9% of cases studied passed compliance standards. Moreover, of 188 cases sold by LAUTRO members only one was deemed to have passed compliance standards, and for transfers sold by FIMBRA members the figure was only 11 out of 172.

The report presented some damning statistics:

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546 *Financial Times*, 11 June 1994, "When he dies my dear, all this will be yours: How the life assurance industry, with such a strong position in society, became accused of a breach in trust" by Peter Marsh.

547 *The Economist* (December 1993) 'Disillusioned with life: Mis-selling British pensions.'

548 Even then, the regulators did not intervene of their own accord. They only intervened when Government ministers started getting a lot of political heat and began publicly criticizing regulators for doing nothing. Once again, it took political intervention to get anything done.

- In 76% of cases insufficient details had been collected of the ceding scheme's early retirement options. In 35% of cases the desired retirement age of the client had not even been established.

- In 44% of cases there is no evidence that it had been established whether the client had dependent children.

- In 75% of cases there were insufficient details on whether the ceding scheme offered discretionary increases to payment and in deferment.

- In 85% of cases there was a "...lack of evidence on the client file of a thorough appraisal of pension alternatives."[550] In addition, in 77% of cases the SRO's reviewers considered that there was "...insufficient information on the client files for a full analysis underlying the recommendation or they considered there to be a problem with the analysis."[551]

- The report also found that in 61% of total cases, the client's attitude to risk had not been reviewed. For FIMBRA cases this figure was 67%.

- Perhaps most damning of all, the report found that the recommendation to transfer was suitable in only 13% of cases.

<u>The Coopers and Lybrand Evidence</u>

A report was also commissioned in 1993 (by SIB) into opt-outs from SERPS. The report, produced by Coopers and Lybrand (once again a firm was asked to produce a report on its competitors!) and published in December 1993[552] reached some strong conclusions:

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[549] "Pension Transfers: A Report by KPMG Peat Marwick", Commissioned by SIB, December 1993.

[550] *Ibid*, p. 18.
[551] Ibid.
[552] See, for instance the Independent on Sunday, March 27, 1994, Helen Kay, "The Private Hell of Pensions."

- 2.4 million of the 6 million people who had bought personal pensions by that time should have never been advised to contract out of SERPS or company pensions.

- 40% of those opting out of SERPS had gross annual earnings less than £10,000 in 1991/1992. These people will be worse off because the pensions' contributions do not outweigh the charges imposed by the life assurance companies.

Interview Testimony on the Pensions Debacle

Whilst pensions transfers may well be in the interests of the customer in certain circumstances, it is difficult to see how opting out of the state SERPS pension scheme is best-advice. The principal reason for this is that SERPS includes a significant contribution from the employer.

IFA Ian Bradshaw[553] commented,

> Now the big companies flogging the pensions knew damn well what they were doing. There's no question, they'd have to be totally naïve not to realize what they were doing at some point wasn't benefiting the customer. But they could get away with it, because there wasn't the regulation in place. Now either the companies should have took a moral stance and said 'No, we will set out our own rules. It's got to be wrong to suggest to somebody in an NHS pension scheme to no longer be in it. We've got to take greater care when we suggest that people move huge amounts of money from these frozen schemes to our scheme.' They chose not to do that, they chose to turn the other way and make money, make hay while the sun shines!

Even more damning in his comments was Laurie Edmans[554], Deputy CEO of NPI:

> Opting out is, as far as I can make out, just about totally indefensible in almost any circumstances, and that's about half the problem.

It is almost inconceivable that the advice to opt-out of SERPS was best advice. Karl Snowden[555], Public Affairs Director for Allied Dunbar noted,

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553 Ian Bradshaw, IFA Bolsterstones Financial Advice, interview 26th March 1998.
554 Laurie Edmans, Deputy CEO, NPI, Interview 27th February 1998.
555 Karl Snowden, Public Affairs Director, BAT Financial Services, interview 3rd March 1998.

Now I think it's very hard for the industry to argue that opt outs are right. Because it's a very simple equation that if your employer puts money into a scheme then you've got to – however good your fund manager is – you've got to do better [in the SERPS scheme]. So I don't think anyone in the industry is trying to defend opt-outs.

This evidence makes it very difficult to avoid the conclusion that regulatory supervision and monitoring must also have been very lax indeed. The regulators had signed off millions of personal pensions and other investment products on their regular compliance visits which it now transpired had been mis-sold. The regulators hadn't noticed the huge scandal unfolding under their very noses. As Mr Greenway MP stated in Parliament on 3rd November 1998, "I know one firm regulated by the Investment Management Regulatory Organization that was commended in the late 1980s and had its records described as exemplary. In the post-1994 regime, even though it took time to get going, the firm was fined £200,000 for the same records."[556] This evidence suggests that, in the early days at least, the enforcement of rules was very lax.

Guaranteed Income Bonds

A number of firms also mis-sold guaranteed income bonds. These bonds offered a guaranteed stream of income over the term of the policy, but in many cases advisers failed to clearly point out to investors that if the investment performance was below that which was planned, the investor would lose all or some of the capital sum. IFA and ex-Midland salesman, Steve French[557], explained:

People see guaranteed growth of 9% a year, and X amount after four years, you know 40 – 50 – 60% guaranteed...Guaranteed income bonds. And we'll give you 9% income for all these years and you think 'Great' because I can't get that much from a building society. What they don't tell them, is that if they don't make that much on the fund – if they only make 3%, that they cash the capital in to make the other 6%! And they're guaranteed to make 9% - yes they'll give them 9% income every year, but they've just cashed 6% in or 9%. And that is, I mean if you look at the guaranteed income bonds, you'll find that's quite common and very well worded. I mean and trying to understand it – you get all your R.J. Temples and flash brokers that send out all these leaflets saying

[556] Mr Greenway, November 3rd 1998, Handard, Common's Debates, part.24.
[557] Steve French, IFA with Accountants Haynes-Watts, 15th May, 1998.

> 9% guaranteed income and what have you, you know superb press write up, superb, best income bond you can buy, yes, but you pay for it out of your own capital. Sounds great!

Free-Standing AVCs

The latest scandal surrounds the selling of Free-Standing Additional Voluntary Contributions (FSAVCs). The Consumers' Association first investigated the selling of FAVCs in August 1996. Phil Telford[558] said:

> we did some mystery shopping, we sent some people around and we did all that kind of stuff. And we found a lot of rule breaches from individual people who were, you know I think PIA had started to get concerned at the stage and had issued guidance saying that you must explain the company's scheme and the ability to take out the in-house AVC as well as the ability to take out free standing AVCs , you must do that. And people weren't doing that – we had them on tape and so forth so we forwarded that to the regulators and to the companies concerned and in two cases they disciplined their salespeople.

However, when the regulators were presented with the evidence, the regulators were surprisingly disinterested. Phil Telford[559] recalled that:

> we tried to move that forward with the PIA, we said 'This is the next scandal, and this is a major problem' and they really tried to fob us off 'Well we'll look at individual cases' – which they did because we had transcripts and tapes and we sent them to them, so they'd looked at those – and the companies stepped in and promised that it wouldn't happen again and all that. But since then they've really just put us off, it's been 'Well, when we have more evidence' and off the record they were saying 'well, we don't really know' and were being very non-committal. So we followed that through with Helen Liddell when she came into office and she's made a couple of statements about it – not just because of us, I mean a lot of people have been saying that this area is one to be wary of – so she's made a few noises about that.

The sale of FSAVCs is questionable because each occupational scheme has to, by law, have an in-house AVC scheme in place which must comply to certain quality standards. The suspicion is that advisers have been selling FSAVCs because of the commission that they generate.

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[558] Phil Telford, Senior Researcher with the Consumers' Associaton, interview 9th June 1998.

Capital Units

A final scandal relates to the use of capital units. Capital units, whilst sounding like 'capital', and thus something good, are in fact another form of charge. To give an example, typically a policy might have a capital unit levy of 5%. This means that those units will only ever grow at a rate of effectively minus 5%. In other words, if the fund achieves 10% annual growth, it will only pass on 5% of that growth to the units. Any increase in premiums will incur additional capital unit levies at 5%. By doing this the company is able to earn substantial commissions. IFA, Steve French explained:

> The company though doesn't need to invest, if we say for example £1,000 with one company, say Equitable would make £20,000 in X years, and with somebody it would only make £4,000 because of the capital units. Then the company knows that it's still making about the same returns as Equitable, so it's still going to have a pot of about £20,000, but they know that they will only have to pay out about £4,000. So what they do is to work the figure backwards, so they take £4,000 and work it back with a compounding calculator to see what they'd need to put in 20 years earlier, they'd probably find that they only needed to put, on average about half in, or probably even less if it's a high capital levy. So they'd only have to put about half in to achieve that £4,000. The question is, where's the other half go? Huge commissions!

Phil Telford[560] argued along a similar vein,

> Well yes, I mean capital units, they sound great don't they, it sounds like capital, it's capital, that means it's good, it means capital growth – sounds great. And then you find that it's a complete swindle. Awful. But – as you know – products still have them. I mean they've been exposed many times, the papers have run stuff on them. They've said that these capital units are widespread throughout the industry and that they are no good – and many in the industry have said 'this is no good. We'll have a different charging structure' but companies still have them.

And as James Hanlon[561], ex-London Life manager said, "Salesman would say, 'You want to buy more capital units because they're cheaper'."[562]

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[559] Ibid.
[560] Phil Telford, Senior Researcher with the Consumers' Associaton, interview 9th June 1998.
[561] James Hanlon, ex-Area Sales Manager London Life, interview April 13th 1999.

4. Failure to Prosecute Criminal Mis-selling

The ineffectiveness of the FSA regime is also apparent from the way in which regulators have responded to individual wrongdoing. Despite evidence of widespread abuse, much of it criminal, the regulators do not appear to have passed on a single case of mis-selling to the police for prosecution. The best that the regulators have done is to issue a number of relatively small fines and reveal the names of some of the companies guilty of serious breaches, and they only agreed to those measures reluctantly, under pressure from the media. Individual directors, who are held responsible for the actions of their salesforces under the Act, appear to have escaped any form of punishment whatever.

The MP for Taunton, Mr David Nicholson,. found it astonishing that since the pensions mis-selling debacle not a single criminal prosecution has taken place. "The deadline for resolving the 300,000 most urgent cases passed in December and only 5% have been resolved. A child of six can work out that, at this rate, most victims will be dead by the time they get their compensation."[563] SIB is obliged to report suspected mis-selling to the police. However, despite confessing that as many as 90% of personal pensions may have been mis-sold, it has not reported a single case to the police. To add to this, the regulators, the Treasury and the DTI disagree about what the law actually means. The DTI described the law as a "matter of interpretation" and insisted that section 47, which governs mis-selling, does not apply to pensions at all, despite its explicit wording to the contrary. It argued the section applied to fund managers misleading the stock market. The PIA and Treasury disagreed with a PIA spokesman stating "Of course the act applies to mis-selling pensions. They are

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[562] There was evidence of mis-selling involving the sale of 'home income plans' in the late 1980s. These schemes involved pensioners re-mortgaging their houses and using the proceeds to invest in insurance company bonds. These schemes were speculative, and led to thousands of older people suffering large losses when property prices fell and interest rates rose, for which they subsequently received compensation. The consumerist Harriet Hall said:

...[T]hink about pensioners and what a vulnerable position they are in...[B]ut the idea that they [companies selling home income plans] didn't stop to think what would happen if interest rates...[went]... down, or if the property boom stopped. You know, the idea that you could put this together and say, 'well, we told them what this is, therefore they are responsible.' I think there is an element of negligence amongst the people who are putting the products together – and these scandals don't really end.

[563] The Sunday Times, 2nd Feb, 1997 "Pensions bosses may face jail", Nick Gardner.

investments, therefore they are covered. But I cannot comment as to whether we have passed any possible breaches on to the relevant authorities."[564]

In addition to the failure to prosecute for criminal mis-selling, the regulators have also failed to impose serious fines on miscreant firms. The fines levied by the regulators are set out in the table below.

Table 6. Fines levied under the Financial Services Act

REGULATOR	NUMBER OF FIRMS FINED	TOTAL FINES (£)
LAUTRO	29	3 600 000
FIMBRA	605	2 292 000
PIA	285	6 511 316

Whilst these fines may appear significant, in proportion to the turnover of the insurance companies they are hardly of any significance. A case in point is the fining of Colonial Mutual in 1993 for an array of rule breaches. The total fine was £130,000, at this time the largest ever fine imposed by the regulator LAUTRO however this amounted to less than a quarter of one tenth of one per cent of their annual global premium income. This amounts to little more than a pin-prick to such a huge organization as CMG.

A major problem for the prosecuting authorities is that while the Act includes a provision in Section 47 (1) that makes it a criminal offence to make misleading, false or deceptive statements when selling investment products, it also says that it will be a defense for a director to "prove that he reasonably believed that his act or conduct would not create an impression that was false or misleading." As Private Eye exclaimed, this clause "is a get-out-of-jail card number one for any director charged over the actions of his commission hungry sales force."[565] There is also a further escape clause for directors of insurance companies and banks accused of responsibility for mis-selling - namely, it would almost certainly be necessary to

[564] Ibid.

prove that a director had been 'reckless' in allowing endowments or pensions to be sold. It would seem (especially given the decision in August 1999 by the Serious Fraud Office not to prosecute over personal pensions mis-selling) that the prosecuting authorities do not consider it likely that this could be proven beyond reasonable doubt in a criminal court.[566]

5. The Pensions Review

The sheer scale of the pensions mis-selling, and the media attention that it began to attract by the early 1990s drew an inevitable (though much prevaricated) reaction from the regulators. This reaction, was the so-called 'pensions review' and it was to prove a watershed for the FSA regime. The review, begun by SIB in 1993, is an excellent example of the failure of the regulators to tackle the industry.

Inactivity and Inaction: 1988-1994

To paraphrase Mark Boleat[567] from a phrase quoted earlier, *everyone knew* what was going on in the late 1980s as far as pensions selling was concerned. Pensions were being sold at an alarming rate, public sector workers were being vigorously targeted and financial services salesmen were making enormous amount of money. It is inconceivable that the regulators were not aware of what was happening. However, SIB delayed, prevaricated and havered. Joanne Hindle[568] commented on the damage caused by the inactions of SIB:

> [There was a]...tendency to too much bureaucracy, a tendency to want to be seen to have

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[565] Private Eye, Number 982, *In the City*, p. 28.

[566] There are also many examples where the regulators failed to deliver compensation to victims of fraud or malpractice. The Knight Williams case is one example of this. The Investors Compensation Scheme (ICS) was supposed to be the final safety net if things went wrong. However, the ICS failed most of the mis-selling victims. Knight Williams was Britain's largest retirement portfolio manager with 24,000 clients and £500m under management. In the late 1980s and early 1990s the company started getting into trouble as investment performance struggled to match the promises made by its salesmen. FIMBRA stepped in and fined it a modest £50,000 and ordered it to pay costs of £23,400 in July 1994. The ICS then started working through 1,250 claims. At first the ICS promised victims that they would receive compensation in Autumn 1996. However, in October 1996 that moved to Christmas and then to January 20th, then to the end of February. Only 10 out of 1,200 people had been offered compensation by May 1997. Since November 1996 5 members of the action group had died, and a dozen had died in the group's three year battle. In addition, two were forced to sell their homes and between 50 - 100 have terminal illnesses.

[567] Mark Boleat, Director General of the Association of British Insurers, interview 26th November 1997.

[568] Joanne Hindle, Head of Pensions, Nat. West., Interview 7th January 1998

got to the bottom of something before saying anything. I mean SIB worked a long time on the pensions mis-selling, it had panels working on it etc, before it came out and said 'There's a problem, this is what we're going to do' If they'd come out a year or 18 months earlier and said 'We're pretty sure there's a problem, this is how we're going to sort it' we would have saved a year to 18 months.

The most vigorous selling took place in the period between 1988 and 1992. Yet the regulators, who were making regulator compliance visits to firms, signed off many pensions sales as compliant with the rules when they were later revealed to have been in breach of rules. In this at least they were grossly negligent.

Complexity and Confusion: 1994-1996

Six years after the first pensions were mis-sold, SIB issued guidance[569] on reviewing pensions cases and a year later in 1995 PIA also issued guidance on the review of pensions business. The deadline for priority cases[570] was the end of 1995. However, this deadline was not met, and so was extended by a year to December 1996; three-quarters of firms also still failed to meet this extended deadline. As if this was not bad enough, there was an additional deadline of June 30, 1996 for people who were 'non joiners' aged 35 or more at the time of being sold a personal pension, or for 'opts-outs' cases aged under 35 and still with the same employer. This deadline was also universally missed. Overall, there were a succession of deadlines for reviewing pension cases – and they were all breached.

The very slow progress of the review (and an indication of its scale) is illustrated by the fact that by April 1996, life assurance companies and IFAs had paid out £6.5m in compensation after 14 months of the review. The total is likely to be well in excess of £10bn. 392,000 priority cases had been identified, redress had been offered to just 7,000. 270,000 of these were from conventional life companies, 62,000 from bancassurers (these have paid £1.63m in compensation). IFAs had offered redress to 6,000 people making a total of £66,000 in compensation so far. Life companies had offered redress to 1,000 people, a total of £4.96m in compensation.

[569] Which was, typically of SIB, in the form of a very sizeable document with incredibly complex flow-charts and diagrams.
[570] Defined as cases where the individual was retired or close to retirement.

Table 7. The Worst Offenders in Reviewing Mis-Sold Pensions as at September 1996[571]

	PRIORITY CASES	ASSESSMENTS COMPLETED
Prudential	41439	10
Co-Operative Insurance	36931	1324
Pearl Assurance	36406	1375
Legal and General	24506	543
TSB Life Ltd	22906	17
Britannic Assurance	19222	3
Hogg Robinson	13716	1
Barclays Life	13130	1030
Abbey Life	12981	8
Allied Dunbar	11761	1424
Natwest Life	10720	179
Sedgewick Noble Lowndes	9787	10
Equitable Life	9561	1654
Lincoln Assurance	9506	1
Royal London	8285	362
Sun Alliance	8249	135
Guardian Pensions	7968	237
GAN Life and Pensions	6998	98
Windsor Life Assurance	6885	72
United Friendly Life	6289	54
Colonial Mutual	5813	14
London and Manchester	5635	22
Norwich Union	5590	53
Refuge Assurance	5114	62
Lloyds Bank Plc	5028	48
Total	361 119	9155

By late 1996, four years after the KPMG report first identified the magnitude of pensions mis-selling, the regulators were little further towards sorting out the problem. The regulators, by frequently refusing to publish the names of those delaying the review (on the grounds that this would not be in the public interest according to PIA Chief Executive Collete Bowe), and in failing to publish the deadlines for the review (on the grounds that there would be a public outcry if the deadline was not met) did little to ensure a speedy resolution to the affair.

Regulatory and Political Expediency

Finally, it took Government intervention in the form of Angela Knight in 1997 to speed things along. The Government, which has tried desperately to stay out of the pensions affair[572], described the regulators' progress as "unacceptably slow"[573] and

[571] Source: Nic Cicutti (1996) "Prudential is Worst Offender in Secret PIA Pension Documents", *The Independent* (30 October).

[572] Because it was the Conservatives (with John Major as Under Secretary of State at the DSS) who unleashed the personal pensions debacle by offering such lucrative incentives to the public to take them out.

the data on firms' offers of redress to investors are revealing of this. Major companies had been excessively slow in reviewing cases, with DBS, the largest IFA Network, top of the 'league of shame' with only 10% of priority cases completed[574]. This is an emphatic indictment of the regulators.

Table 8. Companies completing the least number of pension review cases as of January 1998[575]

COMPANY	CASES IDENTIFIED	ASSESSMENTS COMPLETE	REDRESS OFFERED	CASES COMPLETED AS A % OF TOTAL CASES IDENTIFIED
Countrywide	Figures rejected	by PIA as below	Its quality	Standards
DBS	1302	127	75	10%
Burns Anderson	1013	146	54	27%
Gan	10837	3132	2700	29%
Lincoln National	13113	3251	2322	31%
Friends Provident	6744	2416	2046	45%
Abbey Life	17053	4192	3302	45%

Consumers were denied redress and the damage done to them increased considerably further. The most culpable party was clearly the Government, because it was the Government that had sponsored the new regulatory system and the personal pension scheme, and pushed the necessary legislation through Parliament. Gary Heath[576], CEO of the IFA Association said,

> The Government allowed people to do, frankly, something they shouldn't have been allowed to do. They told us that money being transferred in and out of schemes was the right value when clearly they weren't. And we then added in our own stupidities.

However, the Government was unwilling to admit its responsibility and, in the modern British Parliamentary system, there was little way for anyone to force it to.[577]

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[573] See the Sunday Times, March 16, 1997, Nick Gardner, "Yard Starts Enquiry into Pensions."
[574] See the Financial Adviser, 19 February, 1988. "Small IFA fires return salvo in skirmish with Liddell"
[575] Source: The Financial Adviser, February, 1998.
[576] Gary Heath, CEO of the IFA Association, interview 24th November 1997.
[577] It should not be said that the Government's intentions were totally indefensible. Opposition parties had never liked the Financial Services Act and wanted a much tougher, more powerful and more

At the same time, there was no doubt that the Government was deeply disturbed at the scale of the problem. It was a political time-bomb and a constant source of embarrassing publicity. It also threatened to undermine the Government's attempts to privatize pensions and get to grips with the long-term problems posed by the state pension system. As if that were not bad enough, the scandal also threatened to create panic and destroy public confidence - whatever was left of it - in the UK life and pensions industry. The Government's response was therefore one that any public choice scholar would readily have predicted: the Government adopted the line that the regulatory system was well-designed and that it was for regulators and the industry to sort problems out between them. Government ministers then assured the public that all victims of mis-selling would be compensated in full - though who would pay and how those who died in the meantime would be compensated were never clear. Meanwhile, ministers lectured the other parties on the need for them to sort out the mess they had created, and do it quickly, because consumers were being harmed by further delays. Ministers also made occasional threats that the Government might have to do something if the other parties did not get their act together.

The industry's response was to play for time and put up a smokescreen. Again, this response was exactly what public choice theory would have predicted. No firm had any incentive to agree to a speedy resolution of its outstanding mis-selling cases, and every incentive to postpone the issue for as long as possible. To agree to early resolution would have been to admit guilt, with all its attendant consequences.[578] On the other hand, delay had many benefits. There was always the chance that the Government might bail them out[579] or reform the system to get them off the hook. Delay was also a useful negotiation tactic with disaffected customers, who might be worn down into accepting inferior offers in their desperation to get their cases resolved. In addition, delay was very much in the interests of the individuals responsible for mis-sales and other dubious forms of behaviour: if they could delay resolution long enough, they might have moved on in the meantime or retired, and perhaps escape punishment. The individuals responsible could also hope that even if

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aggressive regulatory agency - something like the SEC in the United States. Ministers were therefore reluctant to admit to the flaws of the FSA system in part - in small part, admittedly - because doing so would have played into the hands of the opposition who wanted an alternative system that could have turned out to be even worse - and still might.

[578] Which could have involved the individuals responsible losing their jobs, facing criminal prosecutions, and so forth.

they got caught in the end, they would face smaller penalties the longer it took for justice to catch up with them: after all, many offences look less serious when they took place a long time ago. Finally, there was always the hope that if they all stuck together and refused to do anything, they might collectively get away with it or at least force the Government or the regulators into some sort of plea-bargain and so escape with much lower penalties.

The plain fact is that firms still have little reason to take the regulators seriously. The net result, not surprisingly, is that progress on resolving outstanding pensions cases has been very slow. By mid 1998, the vast majority of cases remained unresolved, and there was still no end in sight. The regulators had failed abjectly to protect the consumers in their charge.

A Epilogue

Whilst the several million victims of pensions mis-selling still await redress, the individuals at the heart of the problem were rewarded with various forms of honours. The people who developed the personal pensions idea were rewarded for their work: Weinberg and Peacock were knighted, Nigel Vinson received a peerage, Norman Fowler was knighted in 1990 and John Major became Prime Minister. Peter Davis, head of the Prudential and successor to Mick Newmarch was also knighted. Meanwhile, in aftermath of the pensions review two of the former senior regulators were rewarded for their failure. The ex-SIB Chief Executive Andrew Winkler received a Golden Goodbye of £288,000 and ex-PIA Chief Executive Collette Bowe got £281,000 and went on to join a private company on several times her previous salary. These payments must really grate the thousands of mis-selling victims who are still awaiting compensation because of the regulators' failure to fight their cause.

[579] As in the Barlow Clowes affair.

CHAPTER SEVEN

The Effects of the FSA

1. Introduction

This chapter examines some harmful side-effects of the FSA. In large measure due to Coase[580] and to public choice scholars, it has been recognized that regulation is not a costless activity. Although it may deliver a range of benefits, regulation can also impose both direct costs, in terms of regulatory staffing, budgets and compliance costs imposed on regulated firms, and also indirect costs in terms of efficiency losses, reductions in competition and possible moral hazard effects. These harmful effects of regulation are also considered in relation to the FSA. It is argued that the harmful 'side-effects' of regulation (such as the impairment of competition and of choice) were, at least in part, the result of the industry's influence over the construction of the regime and the enforcement of the rules.

This chapter considers six different aspects of the FSA: (i) its effects on competition; (ii) its effects on product transparency; (iii) its effects on the availability of independent advice; (iv) its effects on low income groups; (v) its effects in relation to the partiality of financial advice; (vi) the moral hazard effects; and (vii) its costs.

I shall begin by considering the way in which the FSA has affected competition in the retail investment business industry.

2. The Anti-Competitive Effects of the FSA

Economists have long recognized that a high level of competitive rivalry within an industry leads to greater levels of efficiency[581]. As firms endeavour to compete for customers in the market place, competition leads to lower prices, greater choice and higher quality. In the model of a perfectly competitive market, competition leads to a state of Pareto Efficiency whereby the decentralized market mechanism leads to a perfectly efficient allocation of resources. Regulation has impaired competition in a number of ways.

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[580] Coase, R. (1960) "The Problem of Social Cost", *Journal of Law and Economics*, 3, 1.
[581] Firms produce at a point nearer to the optimal point of minimum average costs.

Barriers to Entry

The FSA regime increased barriers to entry in a number of ways: (i) it laid down minimum prudential requirements for firms wishing to conduct investment business. Whilst the PIA's £10,000 minimum capital requirement was hardly of concern to larger enterprises such as the Prudential, it was a significant burden to the typical IFA; (ii) The regulators also laid down a large variety of administrative requirements in terms of record keeping, computing systems and so forth. Once again, to the small business, these fixed costs of compliance are considerable and will have the effect of deterring entry and causing some existing firms to leave the industry. Indeed, the evidence of this is clear from the number of small IFAs who have left the industry and from the marked trend towards IFA networks[582]; (iii) finally, the requirements as far as training and competence, whilst not as tough as some might have hoped for, did represent a considerable barrier to entry. The costs of training to the basic FPC3 are substantial.

The FSA set down the legal requirement that individuals had to receive prior approval before being permitted to conduct investment business. The requirements for authorization, described earlier, were quite onerous and included the fit and proper test and, under the PIA regime, included quite demanding capital adequacy requirements[583].

The third example of regulation increasing entry barriers was indirect and concerned control of the distribution channel. The dramatic reduction in the number of IFA firms brought about by the FSA significantly reduced the scope for smaller life offices to sell their products. Whilst the banks had their bank branches through which to sell their products, and the large life offices (such as the Prudential) had their direct sales forces, the smaller life offices lost part of their main channel of distribution which had been to sell through IFAs.

A final example of barriers to entry was the imposition of restrictive practices. The most serious of these was the reestablishment of price fixing (in the form of the MCA) until it was outlawed by the European Union. The MCA prevented new entrants paying higher commissions to advisers in order to capture market share; it thus represented a considerable barrier to the entry of new firms.

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582 Which were created explicitly to take advantage of economies of scale in administration costs.

583 The £10,000 own-funds requirement.

Restraints on Trade

The FSA imposed a number of considerable restraints on trade. The SIB, through its rule book (which was then replicated in the rule books of the SROs) sought to codify, implement and enforce a conception of best-practice within the industry. It thus set forth highly detailed prescriptions for exactly how firms should carry out their business, including the records they should keep, how they should sell to and advise investors, and how they should prudentially manage their operations[584]. By imposing a single conception of best-practice – devised months or years in advance - it imposed static inefficiencies and impaired competition. As Goodhart noted,

> The Board...appears to be embarked on a procedure of deciding what is current 'best practice', codifying it, and requiring everyone to ensure that they comply with that. This is 'nanny-state' intervention with a vengeance. Indeed, making everyone comply with 'best practice' is even more ambition than the usual socialist demand that everyone must be, at least, 'average'...there are no economic arguments that I know to support the requirement that standards should be consistently applied at 'best- practice' quality...[this is] likely to inhibit competition and development; codification always does. [585]

Price Fixing

The FSA also – although only very temporarily - re-established commission fixing in the investment industry[586]. As Ross argued "Gower claims that price-fixing is necessary for investor protection...But Gower shows a complete mis-understanding of the beneficial effects of free competition."[587] The notion that price fixing was essential for investor protection is difficult to accept. The MCA was a mechanism designed to allow the life offices to control their costs of distribution and to protect their market share from new companies who were offering better rates of commission to salesmen (principally IFAs). The re-establishment of commission fixing in the Maximum Commission Agreement, by the regulators was as patently an anti-competitive practice as it is possible to imagine.

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[584] And even what wording (and in what font size) should be on business cards and also whether gifts of dairies or calendars counted as indirect benefits or inducements

[585] Goodhart,C. (1987) "Investor Protection and Unprincipled Intervention?", *Economic Affairs*, The Institute for Economic Affairs, February/ March.

[586] The MCA applied to both pure life policies (term assurances and so forth) and also to investment policies such as endowments.

[587] Ross, L. (1984) "Investor Protection – Why Gower is Wrong", *Economic Affairs*, July- September.

3. Product and Status Transparency

Transparency and Competition

In order for consumers to be able to exert competitive pressures on suppliers, it is necessary that they are able to compare and contrast similar products in the marketplace and make informed purchasing decisions. This requires product transparency; if consumers are unable to determine the quality of different products then it is implausible that they can make informed purchasing decisions and exert competitive pressure on sellers. There are two elements to the product transparency issue: (i) whether consumers can determine the charges associated with an individual policy; and (ii) whether investors can make comparative assessments to determine the relative value for money of different products.

The Opaque Nature of Investment Products

It remains - in practice – very difficult for the investor to draw meaningful comparisons between products. As industry executive Karl Snowden[588] made clear "I mean how is Aunt Agatha going to work her way through an illustration? It's a nightmare, it's a nightmare for someone who works in the industry!" This is because products are highly differentiated. Indeed, product providers have done everything possible to distinguish their products in the market by adding a myriad of 'bells and whistles' to their products. The charging structures of products are immensely complex and opaque, and what is more they are purposely so.

A typical personal pension can have as many as twelve different types of charges on it. Whilst this may have a legitimate role in marketing strategy, it is also clear that it severely impairs any attempt at comparing rival companies' products. As disclosure rules have been introduced the product providers appear to have simply increased the complexity of their products to compensate. As a recent Consumers' Association report alleges, "In many cases it is next to impossible for consumers to work out exactly what the charges are because of the euphemisms and obscure language used to describe the charges."[589] The use of complex reduction of yield data

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[588] Karl Snowden, Public Affairs Director B.A.T. Financial Services and Allied Dunbar, interview 3rd March 1998.
[589] Consumers' Association (1998) *Disclosure: Protecting Consumers?* (London: Consumers' Association), February, p.1.

in the Key Features document clearly illustrates this.[590] In conclusion, the report states that financial services are "... the one sector where you can see the concept of confusion-marketing really being put into practice."[591]

Research conducted by NOP for the Consumers' Association in 1997[592] exposed the failure of regulation to deliver product transparency. The research drew a number of findings. The first was that consumers find it virtually impossible to distinguish between different companies' products. As a respondent to the NOP survey stated,

> I wonder how much difference there is. I think they are very similar but the way they are wrapped up can be deceptive. It is very hard for a lay person to know the difference.[593]

The opaque nature of products combined with the lack of comparative data and with the confusion marketing of the product providers makes it extremely difficult for ordinary consumers to make informed purchasing decisions. In general consumers thus consult only one adviser. PIA Consumer Panel data points to a very high rate of investors who only consult one adviser. In 1996, the PIA found that 64% of investors consulted only one adviser, with a mere 4% consulting four or more advisers.[594]

The second finding in the NOP research was that there are very low levels of consumer knowledge. 40% of those surveyed in 1997 by the PIA thought that the best place to obtain independent advice was at a bank despite the fact that none of the banks are IFAs[595]. 61% of investors sampled in 1997 did not realize that financial advisers had to pass examinations[596], and in research conducted in 1997 – almost a decade after the FSA was implemented - by the PIA Consumer Panel, 79% of the total sample were unaware that there was a compensation scheme.[597]

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590 Research carried out by NOP for the Consumers' Association in 1997 found that of 44 people who had recently purchased investment products, only 20 actually had the Key features document in their possession.
591 Consumers' Association, (1998), *op. cit.*
592 Unpublished paper: "Disclosure: Research Presentation" June 1997, NOP Financial.
593 A female client, who purchased a bond from a bank.
594 PIA (1997) Consumer Panel Report.
595 PIA,1997, p.65.
596 *Ibid.* p.57.
597 *Ibid.* p.37.

The third major finding in the NOP conducted research was that the sheer volume and complexity of the information given to clients[598] had the effect of discouraging investors from reading it. NOP presented some disturbing examples. One investor said, "I have never read the front page let alone the back page. I would prefer it in a five year olds terms."[599] Another confessed that, "It is not something I really think about. I throw them into a brief case or a drawer upstairs and that is it."[600] The IFA Dr Thomas stated in his submission to the PIA's Evolution Project, "The proliferation of fact finding paperwork has caused resentment amongst many customers because they do not wish to go through the entire fact find process."[601]

The NOP report concluded that,

> Less than half had a KFD[602] and hardly anyone recognized the term. This lack of knowledge seems due to: (1) The adviser not drawing their attention to it; (2) The amount of literature they receive; and (3) Their own lack of interest and inertia.

Consumers' Association research[603], summarized its findings in the following way:

- Few people in the study were aware of the charges levied.
- There was a general mistrust of the sales process.
- Few shopped around. The reasons given for this were the complexity of the decision process; the vast number of products on the market; and a feeling that all "companies were as bad as each other and there was nothing to be gained from shopping around."[604]
- The majority of people in the sample hadn't even read the key features document.
- Respondents were put off by the sheer quantity of documentation and by the jargon used in it.
- Verbal advice was the most important for investors in making purchasing decisions. Consumers were thus highly dependent on the integrity of the adviser.

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598 Including Key Features documents running to as many as twenty pages in length.
599 A female client, who purchased an endowment from an insurance company.
600 A male client, who purchased an endowment from an insurance company.
601 Quoted from a submission to the PIA's Evolution Project, CP 23, 1997, Dr Philip Thomas, Thomas Financial Planning, p.2.
602 Key Features Document.
603 Consumers' Association (1998), *op. cit.*
604 Consumers' Association, (February 1998), p.2.

- Financial services companies were considered necessary evils.
- The word most frequently used to describe financial services was 'minefield'.

A former area sales-manager of Equitable Life and London Life, James Hanlon, exposed the extent to which some companies will go to ensure that their documentation is unintelligible. He alleged that when disclosure rules came into force, Equitable Life took advice from psychologists on which was the best place to 'hide' the data on commissions to minimize the chances that customers might read it. They were advised to put it two thirds down the third page of the four page document.[605] He alleges that this decision as to where best to hide the commission information emanated directly from the Board.

Status Transparency

Status transparency is also an important factor in investors being able to make informed decisions. A key issue is whether investors actually understand the principle of polarization. The principal public interest goal of polarization was to clarify the status of the adviser. However, according to PIA Consumer Panel data, in 1997[606] 40% of people still believed that a bank was the best place to obtain independent advice, despite the fact that none of the banks are IFAs.[607] There are a number of possible explanations for this: (i) that advisers have not been declaring their status with sufficient clarity; and (ii) it suggests a failure of the regulators to educate the public on adviser status. The confusion in the public's mind over polarization is perhaps not surprising given the way in which the banks, in particular have blurred the issue of adviser status. All of the major High Street names operate as tied advisers but are also allowed to provide independent advice through subsidiary groups, principally to their most wealthy customers.

Two issues are salient on the matter of status transparency: (i) do the terms IFA and tied agent correctly represent the status of the adviser? (ii) do consumers actually understand the concept of polarization?

[605] He also admitted that the Key Features documents could easily have been only half a page in total length!
[606] Almost ten years after polarization was introduced.
[607] PIA (1998) *Consumer Panel Report.* (London: Personal Investment Authority).

In terms of IFAs, polarization, far from clarifying the status of advisers, has actually been misleading to some investors. The title 'independent adviser' and the notion that an IFA will advise the investor to buy the best product on the whole market is in many cases misleading. Many IFAs are not really independent at all[608]. Indeed even Professor Gower argued that they are not. "And the belief that the broker [IFA] will freely choose amongst all companies is false except for the very largest firms. This is because insurance companies like to establish a connection with a known list of brokers and brokers find it convenient to establish a connection with a restricted list of companies."[609] This comment, made of the pre-FSA market applies equally well today. Most IFAs[610] use panels of around a dozen companies and certainly the larger IFAs still find it desirable to establish links with life companies. Although these 'best advice' panels are often adjudicated by external actuaries and the companies on the list are changed regularly to reflect market performance, this in no way represents pure independent advice as implied by the term 'independent'.

Regulatory Failure and Transparency

Throughout the period, the regulators failed to force sellers of investment products to make their products transparent. Whilst the products themselves remain unregulated, the product providers will simply respond to tougher disclosure rules by making the products more complex. The fact that commissions disclosure produced only a 2% reduction in commission levels[611] bears testament to the remaining inability of consumers to shop around, and thus to exert competitive pressures on advisers. Again, Karl Snowden[612] was very frank, "...even if you're an actuary it's difficult to understand the tables."

The initial failure of the regulators to introduce hard disclosure rules or to introduce status transparency was a testament to the power exercised by the industry

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608 As Mark Boleat argued "First of all independent financial advisers are not independent. ...The notion that "we have carefully looked at the whole market and by far the best product for you Is Equitable Life and they don't pay us commission but we are happy to recommend them because they are by far the best product. Here are some forms, go away and fill them in" It's an absolute joke, of course they don't do that, they are concerned with remuneration, they are concerned with commission and of course they are biased to who pays them commission."

609 Gower, L. (1984), *op. cit.* p.90.

610 Especially IFA networks.

611 According to Consumers' Association data, commissions - expressed as a % of premiums - fell from 26% to 24% after hard disclosure was introduced in 1995. (Consumers' Association, 1997).

612 Karl Snowden, Public Affairs Director B.A.T. Financial Services and Allied Dunbar, interview 3rd March 1998.

over the regulators. Karl Snowden[613] said "And there's got to be parts of the industry that are saying 'Thank God for all of the those tables because no one will look at any of the figures and they won't have a clue what they are trying to say." Product transparency is not in the interests of the industry and the regulators have supported the industry in not requiring it.

4. The Availability of Independent Financial Advice

The polarization rules and the heavy cost burdens placed on IFAs had the combined effect of significantly reducing the availability of independent financial advice[614]. This has clear competition implications as well as implications for the quality of advice. Polarization forced institutions to choose between two extreme 'polar' positions: they could provide advice on the products of only one product provider or they could declare themselves to be independent and then provide advice on the whole range of products on the market. The asymmetry between these two options was considerable and had a unfortunate effects on the availability of independent advice.

The Effects of the FSA on the Number of IFAs

The duty of best advice falling upon the IFA was considerably more onerous than for the tied agent. The IFA must consider the whole range of products on the market and conduct a thorough assessment of the client's circumstances and investment objectives before giving advice. Moreover, if the IFA is part of a conglomerate then it must prove that the product of the associate life office is demonstrably better than any other product before being able to justify recommending it. As the DGFT stated in 1987 "It is difficult to see that this proposal....can do other than discourage banks, building societies and other financial conglomerates from seeking to provide independent intermediary services." Thus the rule is likely to "...result in a further reduction in the availability of independent insurance advice."[615]

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[613] Karl Snowden, Public Affairs Director B.A.T. Financial Services and Allied Dunbar, interview 3rd March 1998.

[614] As John Ellis, Director of the LIA asserted "I think polarization back-fired on everybody because in fact what it does is reduce the choice that the consumer has quite significantly - I mean there aren't many proper independent advisers of any size left...there has been a drastic reduction in those giving independent advice." (interview 11th December 1997).

[615] OFT, (1987) The Financial Intermediaries Managers and Brokers Regulatory Association, (London: OFT), p.57.

The MCA - which endured until May 1989[616] - also has the effect of capping the incomes of IFAs. Whilst an IFA was technically free to opt out of the MCA agreement, one who did would fall foul of the hard disclosure requirements. Most IFAs, therefore remained within the agreement. However, the MCA placed no corresponding limit on the earnings of the tied agent - another attraction of converting to tied agent status. After the MCA had perished, the IFA sector was forced to disclose commissions but it took until 1995 for a similar requirement to be introduced for disclosure of expenses and charges for the tied side of the industry.

It was therefore no surprise when the vast majority of the large 'High Street' institutions – who had previously operated, effectively as multi-ties - became tied agents (initially tied to life offices and later to their own insurance subsidiaries: becoming bancassurers). By 1989 of the top four banks and the top ten building societies only Nat West and three building societies[617] were IFAs. The number of building society branches giving independent advice had fallen from 4,740 at A-Day (29 April 1988) to 840 by 31 January 1990, whilst the number of tied building society branches rose from 500 in 1988 to 4,380 by 1990. As of 1998 only the Bradford and Bingley of all the major high street institutions, remained as an independent financial adviser. The number of firms providing independent advice has fallen to less than half of its 1988 level[618].

5. Incentive Structures and the Partiality of Financial Advice

In the absence of product transparency and well-educated consumers, the information asymmetry problems inherent in the investor-adviser relationship become significant. This inevitably makes investors even more dependent on the honesty and integrity of the salesman or adviser. Yet, under the FSA there are good reasons to doubt the likelihood of the investor receiving honest, impartial advice. This is due to the failure

[616] Before being outlawed as breaching competition rules within the Treaty of Rome.
[617] These were the Bradford and Bingley, the Woolwich and the Nationwide.
[618] Gary Heath, Chief Executive of IFA Association told a Treasury Select Committee in June 1998 "When FIMBRA first started in September 1988, you had 9,200 firms [providing independent advice]. The PIA, which is its successor, has 3,500, so it gives you an idea that there has been a significant shrinkage in the number of firms offering advice" (Heath, 1998). It should be noted also, that many of the IFA firms that left the industry left because they could not meet the competency requirements demanded by the FSA in the later years. The loss of many of these firms, should probably be welcomed from an investor protection point of view.

of the FSA to tackle the problem of commission bias. Two manifestations of commission bias remain.

Commission Bias

IFAs can still receive substantially larger commissions for dealing with certain *product providers* over others, and for recommending certain types of *products* over others. Moreover, the lack of transparency of financial products, effectively prevents investors from detecting biased advice. For company salesmen and tied agents, there is also a bias towards certain types of products. For example, salesmen will receive considerably greater commission from selling a mortgage supported by an investment product than by selling a repayment mortgage.

In addition, company representatives are still paid on sales-related commissions, IFAs earn their living from the commissions earned on product sales, and sales-managers within companies are still remunerated on the basis of sales-performance. The vigorous manner in which sales staff pursue new sales is personified in an account from research conducted by NOP for the Consumers' Association in 1997. A male client visited TSB with the intention of taking out a credit card. However, he was asked to complete a financial appraisal form and was persuaded into signing up for life insurance, a personal pension plan and a permanent health insurance policy. The client even confessed that he did not consider the advice to be very good. He stated:

> The advice given by the TSB was not that good but I accepted it. They were not completely sure of themselves. They were dealing with new policies, new systems etc. and they were not that efficient but as they were all there I decided to go with them anyway. They did not know much about it. To be fair, they are a bank.[619]

The client later lapsed the life policy and pension policy and was considering lapsing the PHI policy.

The issue of commission bias has surfaced repeatedly throughout the last decade. Stories have abounded of sales - particularly of pensions, investment products to support interest-only mortgages and life assurance products - being driven by the commissions paid to the adviser by the insurance company rather than the best interests of the investor. Whilst the industry (and especially the IFAs) reject the claims that advice is influenced by commission levels, the most recent research conducted by the PIA indicates that there is a bias. For the first time for 1998, the PIA investigated both a non-weighted index of commissions and a weighted average. The weighted average takes account of the volume of business. If more business is placed with higher commission offices then the weighted average will be higher. In fact, as the PIA report concludes,

> The weighted average commission in the IFA sector is generally higher than the non-weighted average which may indicate a tendency by IFAs to place business with a higher commission office[620]

6. Low-Income Group Access to Financial Advice

A potentially significant side-effect of financial regulation is that it will price low-income groups out of the market. If regulation seeks to impose a minimum quality standard on an industry then it *de facto* excludes from the market those people who are either unable or unwilling to pay for the higher price that higher quality brings with it. Additional burdens placed on sellers by regulation may also result in it becoming unprofitable to sell products to those who can afford only very modest premiums. If the costs of it are substantial, regulation can price a whole raft of the people who are supposedly in greatest need of protection out of the market. As the PIA Consumer Panel report of 1996 noted "Many consumers on lower incomes want to make some long term provision but have little money to spend. These customers may suffer the double detriment of less access to advice, and poorer value products."[621]

There is certainly evidence that the FSA has had the effect of pricing out of the market a significant trenche of the low paid who had previously relied (predominantly) on the home-service providers. To quote Phil Telford,

> [There is a] real danger that costs of regulation exclude people from the market. For the poor could probably get a pension starting at £50 a month but if you went to most advisers they probably wouldn't want to sell you one because it's not worth it to them.

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[619] Unpublished reseach paper, "Disclosure: Research Presentation" June 1997, NOP Financial.
[620] 1998 Disclosure Report, February 1999, (London: The Personal Investment Authority).

£100 - £150 a month to people on low incomes isn't an option at all so there's a danger that they are excluded and will end up with no provision for retirement.

This was confirmed by the Chair of the Consumer Panel, Barbara Saunders, "Yes, one of the costs of imposing a minimum quality standard is that you price out a lot of people from the market...and there is evidence – [including] the withdrawal of many companies from direct selling to people at [their] home[s]."[622]

The home service operated on the basis of visiting the homes of policy-holders and collecting very small premiums[623] which could, over 20 or 25 years, yield a reasonable nest-egg. The home-service traditionally provided for the poor and enabled them to pay for funerals and the like. However, the home-service has seen a rapid decline over the last ten years.

Table 9. The Decline of the Home Service[624]

NEW INDUSTRIAL BRANCH BUSINESS (1987 – 1995)						
Year	New Endowment Policies		New Whole of Life Policies		Totals	
	New Policies 000s	Sums insured £m	New Policies 000s	Sums Insured £m	New Policies 000s	Sums Insured £m
1987	2,335	4,104	509	406	2,844	4,510
1988	1,736	3,148	346	329	2,082	3,477
1989	1,683	3,327	272	295	1,955	3,622
1990	1,796	3,276	255	290	2,052	3,565
1991	1,538	3,287	244	284	1,782	3,572
1992	1,440	3,234	288	307	1,728	3,540
1993	1,046	2,614	167	230	1,213	2,844
1994	797	2,157	186	243	983	2,401
1995	544	1,556	126	184	671	1,741

Although there is debate as to the extent to which the decline of the service was due to the impact of regulation and specifically to whether the service would have continued to be viable anyway given the huge costs and poor returns, there can be no doubt that

621 PIA Consumer Panel Report, 1996, (London: Personal Investment Authority).
622 Barbara Saunders, Chair of the PIA Consumer Panel, interview 31st March, 1998.
623 Often as little as a few pounds paid usually on a weekly or sometimes a monthly basis.
624 Source: Insurance Statistics Year Book, 1985-1995, (London: Association of British Insurers).

the effects of regulation have been to hasten the collapse of the sector.[625] As can be seen from the above table, the decline has been dramatic with both new policies and amounts insured declining rapidly over the period.

It is now the case that

> Very few companies outside the Friendly Societies provide for low income consumers. It has been suggested that many IFA's are not interested in dealing with customers who have less than £50 a month to invest. This is an indictment of the high cost of regulation brought about by an overstaffed, overpaid regulatory authority.[626]

Indeed John Ellis, an ex member of MIBOC, argued that the collapse of the home service one of the goals of Professor Gower,

> ...the...home-service...[has] never been a very good deal but I remember Jim Gower saying 'the one thing I can do is to stop them selling like that then I'll think I've achieved something'...[T]his is a very middle-class view, in actual fact these people were better off having something like that...[than nothing at all.][627]

The attitude that low-income members of the public are better served by having no cover rather than very poor value cover is attacked by Joanne Hindle: "[If] my husband falls under a bus, I'd much sooner have some life insurance even if it's poor value than none at all!" She continued,

> [T]o have a process that is thorough and takes two hours and an hour back in the office doing research is much more time consuming and therefore expensive, than for me to meet you in the pub for ten minutes and say to you 'Sign this form'. So if I'm Mr Fat Cat and I'm paying in £10,000 a year the fact that it costs £500 doesn't matter that much, but if I'm Mrs Thin Cat and can only afford to pay in £600 a year, and it costs £500, so I've only saved £100! Yet, in a way, the less you've got, the more important it is that the advice you get is proper and professional because it's more important to you. If I've got £10,000 to invest,

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[625] The Prudential gradually withdrew from the home service in early 1990s, blaming the costs of regulation. Most of the other traditional home service providers have also gradually withdrawn from this sector also.

[626] Quoted from a submission to the PIA's Evolution Project, CP 23, 1997, Dr Philip Thomas, Thomas Financial Planning, p.5.

then if £1,000 doesn't quite go right then so what. If I've got £500 to invest and £400 of it is wrongly invested then that's a big problem...What we've done at the moment - as you mention with the decline of the home service - is meaning that more and more people aren't getting access to advice at all, because they can't afford it or the companies who supply it have decided that they can't provide it. But is it better that they get nothing or they get very expensive advice that they can't afford.[628]

Karl Snowden concurred,

...the commentators are saying that the IB branch has had to go because it's not good value for money. What it means is, it's not cheap in terms of what it provides out the other end. But if you add in everything else that it provides then maybe it is worth it...what I am saying is that the service provided by the people that went down to the doors was exactly the kind of service I'm describing, they actually said 'now, Mrs Jones you need to think about this, this and this. You need to think about your funeral plans and about little Johnny. Now that your daughter has run off with the milkman and you are looking after little Johnny you've now got to think about it.'"

7. The Moral Hazard Effects of Regulation

Imperfect competition makes it difficult for investors to judge the quality of investment advice that they are given. Regulatory intervention sometimes seeks to solve this problem by regulating the quality of advice and giving the investor a guarantee of this quality. The outcome envisaged by Akerlof (1970), where severe asymmetric information can lead to a market failure is thus avoided. However, such a guarantee of quality can have negative side effects; specifically quality guarantees can lure investors into a false sense of security and thus create a moral hazard effect. Moral hazard, in this context, refers to the way in which regulation can change consumer and institutional behaviour in a way that is perverse to that originally (and supposedly) intended.[629]

There is evidence to suggest that regulation in general and specifically such concepts as best advice and suitability have had a moral hazard effect causing investors to take more risks in the belief that standards are guaranteed by an external

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627 John Ellis, Public Affairs Director of the Life Insurance Association, interview 11th December 1997.
628 Joanne Hindle, Head of Pensions, Nat. West., Interview 7th January 1998
629 See Shapiro 1986; Goodhart 1989; Llewellyn 1995.

agency. Although most of the research on the moral hazard effects of regulation is on the banking sector,

> ...all the above arguments [concerning the creation of moral hazard by regulation in banking] apply with equal force to any institution (or person) seeking funds from investors for any reason, in any form. Investors may place funds without sufficient regard to safety not only with banks, but also with all other deposit-takers, all mutual fund investments, unit trusts, fund managers and brokers of all kinds. The dishonest, the gambler and the incompetent might all find it easier to attract other people's money because of the imprimatur given by a license from a regulatory authority.

He continues, "...regulatory requirements might induce economic agents to take excessive risks when part of the consequences are borne by others."[630]

The Government guarantee of best advice is likely to have a similar effect. Consumers are encouraged to take more risks (do less research, take less care in the purchasing decision, undertake less monitoring) and this is to the advantage of the salesman. As Llewellyn argues "...because there is an authorisation procedure, specific aspects of regulation are established, and that the supplier of financial services is in some sense authorised and supervised, that the institution is therefore safe." He continues "The obvious danger is that an implicit contract creates the impression that the consumer need not take care with respect to the firms with which he or she deals in financial services. This becomes a moral hazard of regulation , a hazard that regulation itself creates the image that less care need be taken."[631] The increased incidence of mis-selling – or perhaps mis-buying - since the introduction of the FSA indicates the extent of the moral hazard effects of government quality guarantees. As the Home Income Plan Action Group told the Parliamentary Select Committee inquiry of 1993, the elderly victims of mis-selling had been lured into a false sense of security by the LAUTRO and FIMBRA logos on sales-men's letter-heads.

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[630] Gowland, D. (1990), *op. cit.* p.23.
[631] Llewellyn, D. (1994), *op. cit.* p44.

In addition to these anecdotes of moral hazard effects, the evidence on the lack of research carried out by investors prior to making important purchasing decisions[632] is suggestive of a moral hazard effect. As The Economist argued in 1990,

> Mr John Redwood...Britain's corporate affairs minister...told City Regulators to give investors much tougher protection against 'fraud, theft and daylight robbery'...His words help to entrench an already tempting notion that the duty of the regulators is to prevent wrongdoing. The implication is that when it happens...the regulators will have been at fault, so investors deserve compensation. Such nannying only makes recklessness and fraud likelier in future...Mr Redwood knows that regulators cannot offer complete protection. But the risk is that his words will raise expectations too high.

8. The Costs of Regulation

It has been widely recognized after Coase[633] that regulation imposes both direct and indirect costs. Direct costs include the administration costs of running the system, including the regulatory budgets and so forth. Indirect costs include compliance costs. Compliance costs are notoriously difficult to estimate because they relate to the additional costs imposed on an industry by regulation. Also included within indirect costs are those even less calculable costs that are imposed by regulation on society as a whole; these include the anti-competitive effects of regulation and static inefficiencies.

The array of costs are ultimately paid for by the consumer, in terms of higher charges and commissions or in terms of higher prices that result from lower levels of competition. Astonishingly, however, during the period in which the FSA has operated there have been scant few attempts (certainly by the regulators) to calculate the costs imposed by regulation. The first substantive attempt at an estimate of the

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[632] As NPI deputy Chief Executive Laurie Edmans stated "We did some research 5 or 6 years ago now, which very, very crudely divided investors into three types. The top 5% who really were expert in the particular area that they were going to invest in – and actually knew more than the advisers or the providers...Then there are, the next 45% are people who understand a bit, and when they are making a purchase they try to find out, some of them about 25% do get to a point...They've tried to research and they get right up to the thresh-hold and then their nerve goes – it's too important! And what they do and the next 25%, who do some research, but never quite get there, what they do, is they get to a point, they've done some research and they get to a point where they realise how complicated it all is, and they therefore find someone that they trust, all the things they've learnt go out of the window and they rest on the person they trust. The final 50% don't even try and find out, they either don't do anything at all or they just rely utterly on the person giving them the advice."

[633] Coase, R. (1960) *op. cit.*

direct costs of the UK regulatory regime was the work undertaken by Franks et al in 1993. They started from the 'guesstimates' made by David Lomax (1987) that the regime would cost in the region of £100 million per annum, with the direct costs of running the regulatory agencies totalling £20 million per year. In fact, Franks et al did find that the Lomax estimate was, as suspected, a gross under-estimate. The direct regulatory costs of the SIB and SRO's were found to be nearly double, in real terms, those estimated by Lomax.

In a later paper Franks et alia (1996) attempted to provide the first assessment of the indirect costs of the UK regulatory regime. They also sought to compare their estimates of compliance costs to those made by Lomax (1987), who had estimated a compliance cost multiplier of four[634]. They found that direct costs were almost double the estimate of Lomax and that the compliance costs were several times greater than direct costs. Franks et alia also found that the burden of both direct and indirect costs varied according to the size of the firm, with the smaller firms bearing higher relative costs. They argue that the burden of costs fell disproportionately on the smaller firm. In fact, this finding correlates with work done by Bannock et al (1995) who found that,

> Because of a large fixed-cost element in compliance, these costs are regressive by firm size: they bear most heavily on the smallest firms.

Bannock et al (1995) argued that although IFAs accounted for only 41% of total new life assurance premia earned by the major distribution channels, they bear 60-70 per cent of direct and compliance costs. An indication of the increase in costs imposed on IFA firms over the development of the FSA regime is given in the table below.

[634] This means that for every £1 of direct costs, there will be £4 of compliance costs - which gave a total of £100 million per annum total based on direct costs of £20 million. In the famous study by DeFina and Weidenbaum (1978), the compliance cost multiplier was found to be 20.

Table 10. Costs borne by typical Fimbra/ PIA members[635]

	FEES (£)	ICS (£)	PI (£)	TOTAL (£)	Annual average rpi (jan 1987 = 100)	Fees deflated by rpi (1988/ 89 = 100)	Total deflated by rpi (1988/ 89 = 100)
1988-89	700	-	287	987	103.9	100	100
1989-90	930	439	358	1,727	115.2	123.3	162.4
1990-91	943	631	448	2,022	126.1	114.2	173.7
1991-92	1,135	690	560	2,385	133.5	129.8	193.5
1992-93	1,210	1,200	700	3,110	138.5	133.4	243.2
1993-94	1,330	1,425	1,500	4,255	140.7	144.4	327.5
1994-95	1,550	(1,500)	(1,750)	(4,800)	144.1	164.3	360.8
1995-96	(1,693)				149.9	172.5	

These data indicate a rise in costs (excluding compliance costs and efficiency costs) over the period 1988-1995 of over 350% in real terms. These findings are suggestive of at least one of the reasons for the dramatic decline in the numbers of IFAs over the period of the FSA.

In conclusion, the FSA regime was far more costly than ever imagined by anyone at the time of the passing of the act.[636] Indeed, Bannock and Peacock estimated the total costs of the regime to be £330m per annum (Bannock *et al.,* 1995). It is ironic that a number of minor scandals in the early 1980s - the most serious of which causing losses of £12m - should have led to a regime costing so much. However, it is likely that the £330m estimated by Bannock et al are themselves gross underestimates of the true costs of the FSA as these estimates still ignore other important costs.

9. Conclusions

Chapter five explored the private interest origins of the FSA. This chapter explored the ways in which the FSA imposed harmful side-effects on the industry and on the investor. The overall conclusion being that regulation caused a number of damaging side-effects. Investors were forced to suffer a reduction in choice, lower levels of competition, from an even more complex and confusing sales-process, and from biased advice. In addition, there is clear evidence that one (inevitable) effect of the FSA was to price the poorest out of the market altogether. A further effect is that the cast-iron protection that regulation promised to investors actually had moral hazard

[635] Bannock et al, (1995) *op. cit.*

effects the effect of luring them into a false sense of security. In this way, regulation had a moral hazard effect whereby investors behaved more recklessly and thus exposed themselves to potential losses.

Although it is inevitable that any policy will have costs as well as benefits, and that the costs documented above may be a price worth paying for increased levels of investor protection, it is clear that these costs must at least be considered when drawing conclusions on the overall success of the FSA. Are the harmful side-affects a legitimate price of trying to prevent serious scandals and financial fraud?

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[636] Whilst the estimates made at the time that the Act was passing through Parliament suggested that the total costs would be around £100m[636], the actual costs have been much greater.

CHAPTER EIGHT
OVERALL CONCLUSIONS

1. The Interests Served by the FSA

On the 29th April 1988 the FSA came into operation. This Act was supposed to ensure the safety of those investing in often-complex investment products. It was to ensure that salesmen did not rip off Aunt Agatha, and that even if they did, she would receive redress and the wrong doer would be punished. However, in my thesis I have presented empirical evidence to support the contention that, in the early days at least, the FSA failed in this objective. Moreover, I have argued that the cause of this failure was that industry interests captured the regulators. My principal findings are presented below.

The Origins and Passage of the FSA

- The impetus for the FSA was grounded in a Government reaction to intense media criticism that followed a serious of minor, but politically embarrassing, scandals.

- The process of constructing the new regulatory regime was – inevitably - based on consensus and co-operation between Government and industry interests. However, the dominant influence on the new regime was a number of industry dominated committees.

- Scandals in the city and heightened competition in financial services aroused demands from industry interests for protective regulation.

- The Government's desire to satiate the interests of the industry led to a compromise Act that was confused, very complex and costly.

- The institutional structure established by the Act was flawed in a number of respects and was thus, from the very start, unlikely to be capable of effectively implementing the FSA. The founding principle of self-regulation within a statutory framework was in practice a system for giving the industry virtual carte blanche to do as it pleased.

The Capture of the FSA

Private interests within the industry profoundly influenced the subsequent development of the regime. The strongest evidence of the influence of private interests on the development of the FSA regime is found in the ways in which the regulators, in support of sections within the industry, resisted the introduction of various rules designed to promote the interests of investors.

- Standards of competency. As was documented in chapter five, it took the regulators until 1995 before there was a requirement for a mandatory standard of competency for financial salesmen. Even then, although the FPC was rather easy, some salesmen found it too difficult, and the PIA had to introduce special dispensation to allows salesmen who hadn't passed the exam to continue selling as long as they were supervised by someone who had passed. Although the exams became much tougher in the late 1990s, especially when they were taken over by the Chartered Insurance Institute, the failure of the regulators to introduce professional exams for so long was in large measure because the industry (and especially the banks) did not want to countenance the enormous costs that professional training would impose on them.

- Hard disclosure. Another area in which the regulators exhibited their capture by industry interests was in resisting the hard disclosure of commissions and charges on investment products for so long. The industry was adamant that it should not be forced to disclose and the regulators (spearheaded by SIB) supported this view against consumerists, politicians and the OFT who were all arguing for hard disclosure as a mechanism by which consumers could make informed decisions.

- Commission driven selling. Investment products, especially in the period of pensions mis-selling, were sold by poorly trained salesmen who were incentivised by the most powerful of financial carrots and sticks. Success meant huge monetary rewards, but failure meant humiliation in the short run, and in the longer term, it meant redundancy. The short-term bias towards the maximisation of sales is strong enough to negate even the most idealistic of sound bites such as 'best-advice'. The failure of the regulators to tackle the incentive structures at work within the financial services industry again illustrates the power of the industry in dictating regulatory policy.

- Individual registration. As in the cases above, individual registration was opposed by powerful elements within the industry; its cost implications for the large insurance companies and banks were enormous and so it was resisted with some vigour. The regulators failed to introduce individual registration until 1997.

- The conduct of the regulators in the pensions review was also instructive of the interests that they were serving. They avoided the problem until media attention provoked government intervention. They then allowed the industry to haver and delay the process and were complicit in a conceit of obfuscation, concealment, secrecy and mis-information.

The Failure to Enforce the Rules

- The enforcement of rules in the early days was rather lax. Pivotal rules such as the requirements for record keeping and to give best advice were commonly flouted. I have presented evidence on non-compliance and on the attitude of managers and salesmen to compliance with the rules.

- The rules that were enforced appear to have had an array of anti-competitive and other harmful side-effects including:

    - Reducing the availability of independent financial advice.

    - Pricing the poorest out of the market for investment products.

    - Impairing competition within the industry at a time when wider competitive forces were working to make the industry more competitive.

- The failure of the regulators to prosecute criminal mis-selling or to bring the directors of mis-selling companies to task is also instructive of the failure of the regulators to protect the interests of the investor.

<u>Public Interest versus Public Choice</u>

As has been argued throughout the thesis, the literature on the interests served by regulation is dominated by the theoretical polemic of public interest versus private interest. A number of conclusions are drawn from the study on the theories of regulation.

- The public interest theory does not seem to provide a plausible explanation for the origins of the FSA. There is little evidence to support the contention that regulation emerged as the result of some process aimed at the correction of market failures. Indeed, market failures were not even identified and no studies were conducted to determine the cost-benefit implications of alternative regulatory course of action.

- As public choice predicts, the origins of the decision to regulate appear to have been in a combination of political response to scandal and private interest demands for protective regulation. Altruistic concern for the public interest does not seem to have been the motivating force behind the FSA.

- The hypothesis underlying the public interest theory - that regulators will implement regulatory rules impartially and without bias - is undermined by the evidence presented on the behaviour of the regulators. Far from impartially implementing the rules to the benefit of the consumer, the regulators failed to implement most of the rules and they resisted rules that would appear to have been essential to investor welfare.

- The conspicuous failure of regulation to achieve its objectives of protecting 'Aunt Agatha' is supportive of the public choice theories assertion that regulation seldom achieves its 'public interest' objectives; this is because the regulators actually pursue their self-interest and tend to be captured by industry interests.

Although it is clearly the case that the regulators did eventually come to grips with regulating the sellers of investment products - they introduced training and competency requirements, disclosure requirements, individual registration and also started to address issues of consumer education - the capture of the FSA regulators in the early days, and the attendant consequences of this should be a stark warning for the future. This thesis has presented powerful evidence to support the contention that in the early days of the FSA, the regulators, supposedly there to protect the investor, actually helped the industry to exploit them. The regulators failed to enforce the rules and a series of scandals followed. It is to be hoped that UK policy-makers have learnt from the FSA experience; if they haven't then one can only hope that Karl Marx was wrong when he said that those who fail to learn from history condemn themselves to repeat it.

A Future Research Agenda

This thesis constitutes an investigation into the interests served by, and the effects of the FSA. However, despite this study, the area remains massively under-researched. It is surprising that such an important example of government economic regulation, and such a fascinating study in public policy has attracted so little scholarly attention.

Further research is urgently required into the costs and benefits of the FSA. Whilst I have attempted to consider the costs of regulation and have given an indication of the likely benefits, it is undoubtedly the case that from, for example, a macro-economic perspective, there are a myriad of costs and benefits that have never been considered in any the studies. Such factors as the increases in employment in the industry as a result of regulation (and the consequent explosion in the compliance 'industry') could be considered as a macro-economic benefit. Equally, the issue of whether scandals would have been more severe and more damaging (both to investors and systemically) could be considered in a comprehensive assessment of costs and benefits.

In addition - and perhaps as part of a comprehensive study of the costs and benefits of the FSA - the effects of the FSA, particularly the moral hazard effects of regulation of this kind, also demand study. The literature on moral hazard is almost exclusively related to banking. The study of moral hazard effects in the wider financial services industry thus merit attention.

Finally, this thesis has exposed some fascinating case studies in operations risk. This is a relatively new area in financial economics and its application to such phenomena as the pensions mis-selling debacle and particularly the way in which firms sold products with apparent disregard for reputation risk or legal risks (liability for mis-selling and so forth) demands close scrutiny.

Postscript: The Labour Reforms of the FSA

The election of Tony Blair's Labour government in May 1997 brought with it reform of the regulation of investment business. In opposition, the Labour party had made clear their support for a fully statutory system of regulation; indeed the Labour party had advocated this since the early discussions on the FSA in 1985-1986. Soon after coming to office, New Labour announced that they would be repealing the FSA and replacing it with a new Financial Services and Markets Bill. The nouveau régime was to have the statutory Financial Services Authority as its centrepiece. The Government's consultation document on the new regime stated that:

> The Government promised reform when we came into office last May, setting immediately in train the replacement of the existing patchwork of regulators with a single statutory regulator. We intend to put in place a regulator that is independent and flexible in its day to day operations, accessible to those it regulates, and those whom it seeks to protect.[637]

The specific proposals in the FSMB are now considered.

The FSMB Proposals for a Brave New World

The Financial Services and Markets Bill (FSMB) and the establishment of the Financial Services Authority is the latest in a long series of reforms. Although at the time of writing, the FSMB was yet to pass through Parliament, the Act is likely to lead to a regime which is, at least on paper, more coherent and better organized than that implemented by the FSA. I identified a number of flaws in the *ancien régime* and many of these were slowly being addressed in the last few years; for instance individual registration, the FPC and something like disclosure was introduced. In addition, several of the flaws have been addressed in the FSMB. Indeed, the Government's started position was to recognize that the FSA had failed:

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[637] HM Treasury (1999) "Financial Services and Markets Bill: Consultation Document" (London: HMSO), Forward by Gordon Brown.

> The Government believes the current system is costly, inefficient and confusing for both regulated firms and their customers. It is not delivering the standard of supervision and investor protection that the public has a right to expect.[638]

The proposals are as follows:

- The panoply of regulatory bodies established under the FSA regime will be replaced by a single, statutory regulatory body called the Financial Services Authority. Not only is this body statutory and thus in theory more independent of practitioners, but it is also a regulatory body for all financial services (including banks). There is thus less scope for overlap, competition in laxity and confusion.

- The Government expressed concern to establish a Bill that did not make "unnecessary distinctions between different sectors of the financial services industry."[639] The Government also expressed concern over the exclusion of mortgages and of Lloyds from the FSA, it also conceded that "it is not the Government's objective to make major changes to the scope of regulation."[640]

- The new Bill emphasis consistency and transparency in the new regime. In addition, the importance of considering both costs and benefits of rules is iterated. As is the opportunity that the advent of a single regulator will offer scope for some rationalization of rules.

- The Bill advocates a greater emphasis on the assessment of operational risk and on more sophisticated regulatory techniques.

- The problems of regulatory arbitrage and competition that existed under the FSA, where different regulators had different powers of investigation, enforcement and punishment are expunged by the existence of a single regulator under the FSMB.

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[638] *Ibid.* p.1.
[639] Ibid.
[640] Ibid.

- The FSMB adopts the same requirement as the FSA that rules should have to be assessed for harmful competition implications.

- The Bill places emphasis on the need for financial markets to be open, transparent and fair. The importance of disclosure is stressed.

- The panoply of ombudsman schemes and the complexity of the complaints procedure is being addressed and in the new regime there will be a single point of entry for complaints.

However, despite these ostensibly promising features of the proposed new regime, there are some areas for concern.

The Financial Services Authority: Too Big to Fail?

The FSA is a huge organization, with a staff of over 2,000 people occupying a whole building in Canary Wharf. Given the way in which the PIA succumbed to empire building and self-serving behaviour, there must be serious questions as to the likelihood that the new regulator will deliver *cost-effective* investor protection.

There must be serious doubts as to how effectively the new regulator will be able to regulate such a broad constituency that spans the gulf between the several thousand small IFAs scattered across the country to the huge financial institutions in the City. Indeed, the FSA doesn't even have an office outside London, which is suggestive of where the main focus of its attention will be.

The Financial Services Authority will regulate approximately 34,000 businesses, including:[641]

Banks	550
Building Societies	70
Friendly Societies	280
Insurance Companies	800

[641] Data from HM Treasury (1999) "Financial Services and Markets Bill: Regulatory Impact Assessment", (London: HMSO).

PIA Firms:	
Authorized	4,000
Appointed Reps	10,500
IMRO firms	1,050
SFA firms	1,300

The Financial Services Authority will also have significant responsibility in relation to Lloyd's of London. Its responsibility will be for at least 13 members' agents and 65 managing agents. In addition, the 16,000 professional firms of solicitors and accountants, which were regulated by a plethora of professional bodies under the FSA, will now be regulated by the Financial Services Authority. On top of this, are a further 13,000 mutual organizations.

In sum, there is a very real danger that protecting Aunt Agatha will be marginalized by the tasks of regulating banking and the wholesale markets.

Judge, Jury and Executioner

The Financial Services Authority is not only the regulator of investment business but is also the body responsible for taking in and adjudicating complaints from investors, and also, where appropriate, for punishing firms. In the consultation documents and in the draft bill, it was envisaged that there would be no independent body for complaints. The Financial Services Authority is thus to act as judge, jury and executioner. This concentration of power in the new regulator's hands runs contrary to all principles of natural justice. Accusations that the Financial Services Authority was to be a law unto itself has drawn some murmurings to the effect that the Authority may defy the Government and establish an independent body for dealing with complaints. This would be an astonishing embarrassment for the Government.

A Danger of Regulatory Capture

Finally, and most seriously, given the size, scope and powers of the FSA and given the well-documented success of the industry in capturing the previous regulators, there must be serious concerns that the new authority will also succumb to industry interests like its predecessor. The FSMB, appears to be a prime candidate for this; like the SEC in America. Indeed the literature, reviewed in chapter two, suggests that it is regulatory bodies like the SEC and the Financial Services Authority which are huge, quasi-governmental bodies that are most prone to capture by industry interests.

Whilst it is true that much of the blame for the failure of the old system – and for the pensions scandal - must be laid squarely on the Conservative Government of the time, it appears that New Labour is making similar mistakes. New Labour has opted for the state regulatory option. Almost weekly new regulatory bureaucracies are created or new regulatory initiatives are unveiled. Yet the performance and effectiveness of such institutions and schemes is rarely, if ever, seriously examined. Whilst one must be hopeful that the FSMB will deliver on the Government's promises, the balance of evidence suggests that once again the mere existence of imperfections in market based control mechanisms will have encouraged a state bureaucratic response which may be even worse. The words of Churchill on democracy should be remembered: that however imperfect the market is, it is often the least worst of all available systems.

Appendix

Interview schedule

The following schedule of questions was used as a guide for the interviews. In cases of interviews with consumerists (for example) the questions related to the effects of regulation on the interviewee's firm were omitted.

Part One: Effects of regulatory policy on the industry.

The impact of regulatory policy on the industry has clearly been substantial, with costs at over £250m per anum, but I would be interested in your opinions on some of the more specific effects of regulation:

Competition.

1. There were accusations at the time of the implementation of the FSA that it would severely reduce competition in the market - at a time when rapid advances in IT and the globalisation of financial services were giving a major spurt to competition. Has the FSA had such an effect on competition and what would you estimate is the extent of this effect?

2. If the FSA has had a negative effect on competition what are the elements of regulation that have most caused this effect?

3. To what extent does the FSA limit your ability to diversify and enter other market segments? Does it make otherwise viable diversification initiatives unprofitable? Can you give examples?

4. Has regulation given a competitive advantage to any specific sectors of the industry? If so, to which groups and how?

Market structure.

5. The industry has been increasing in concentration for some time. However, do you believe that regulation has caused an increase in market concentration in the retailing of insurance and other financial services? What has been the extent of this effect?

Quality. The economic rationale for licensing and other quality based regulation is that the market incentives of (i) liability in the event of negligence, and (ii) reputation, fail due to information asymmetries.

6. To what extent has regulation achieved an increase in average quality standards and what have been the side effects?

7. Has a minimum quality standard been established in terms of advice from salesmen? How has this been achieved? Can you ever offer a guarantee to investors that their advisers are competent and honest?

8. Has regulation, specifically the licensing element (authorisation) and training requirements brought about an increase in the competency of financial services salesmen?

9. Regulation which raises quality standards (by forcing firms to train salesmen to a set minimum level and by imposing best practice quality standards) can price people who don't value high quality out of the market in this way. Have, in your experience any groups of people found themselves priced out of the market?

Part two: The Regulatory agencies.

1. What opportunities is the industry given to contribute to the formulation of regulatory policy?

- Of the SIB?
- of the SROs?

Can you describe these opportunities?

2. How much influence do you feel that the industry has had on regulatory policy as opposed to the influence of government and consumer bodies?

- Initial regulatory regime – incl. Polarisation etc
- New Settlement 1989 – 1992
- PIA and hard disclosure

3. Do you feel that all sectors within the industry are given equal consideration in the making of regulatory policy?

4. Have the opportunities to influence policy and the level of influence changed over the last decade?

- Pre 1990?
- Up to the establishment of PIA?
- Since the establishment of PIA?

5. There was a general belief in the media that FIMBRA and probably LAUTRO were merely trade associations rather than regulators. Do you believe that there is any truth in this notion?

6. The PIA has appeared much tougher towards the industry than its predecessors. Indeed Jim Stretton and Mick Newmarch both lambasted the PIA for no longer being a self-regulatory body. How would you characterise the way in which the PIA has gone about its regulatory task?

7. Are the regulators more or less open to suggestions and advice from the industry now?

8. To what extent do you believe that government political motives have shaped regulatory policy? – for instance the symbolic political value of establishing the PIA after FIMBRA and LAUTRO were tarnished with the mis-selling scandals.

Part Three: Your firm or sector

If you represent a sector of the industry:

1. Do you believe that your sector of the industry has been adversely affected (compared to other sectors of the industry) by regulatory policy

- Before 1990?
- Up to the establishment of the PIA?
- Since the establishment of the PIA?

2. How has regulation adversely affected your sector of the industry compared to other sectors?

3. Can you identify specific examples of policy, which you believe have had a deleterious effect on your sector of the industry compared to other sectors?

If you represent a firm within the industry:

1. Could you give me some idea of the magnitude of costs imposed on your firm by the Act - for instance how many compliance officers are required?

2. What opportunities are you given to influence regulatory policy?

3. Are you in frequent contact with the regulator - is the relationship a partnership?

4. Could you tell me how many visits by the regulator you would typically receive in a year? Has the frequency of visits changed over the last decade?

Part Four: The investor

The Rationale for regulation

1. How would you define the public interest goal of investor protection?

2. To what extent should the investor rely on their wits and competition?

3. How can a regulator provide a guarantee to the investor against loss or fraud?

4. What are the objectives of regulation in financial services?

The level of protection

4. Do you believe that the FSA has increased the overall level of investor protection? Do you believe that the FSA has made investors better-off overall?

5. Do you believe that the FSA creates a moral hazard effect whereby investors, believing there to be an implicit contract of protection between themselves and the regulator, act more recklessly in making investment decisions?

6. If so, do you believe that the moral hazard created by the FSA was a contributory factor in the pensions and other so called mis-selling scandals that have occurred?

7. Would the pensions scandal have occurred in the absence of the FSA?

8. How would you rate the general level of consumer awareness/ knowledge of financial products? Is the level of awareness a function of the protection that they have been promised?

9. Do you believe that the regulators are focusing sufficient attention on the issue of consumer education?

10. Do you believe that consumers have been given enough say in regulatory policy or have the regulators behaved rather paternalistically?

Part Five: Reflections on the FSA

Given that the FSA regime is going to be replaced by a fully statutory system of regulation overseen by an SEC style body called NEWRO, what are your reflections on the last decade under the FSA?

1. With the benefit of hindsight, why do you think the revolutionary step was taken to implement the FSA regulatory regime?

2. Do you think that the industry anticipated the full consequences of the FSA?

3. How would you now reflect on the FSA? - do you think that the costs have outweighed the benefits? What do you are the three main costs and the three main benefits of the regime?

4. Who have been the winners and losers under the FSA?

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