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BOOK REVIEW

The Transformation of Threadneedle Street: The Deregulation and Re-regulation of Britain's Financial Services. By James J. Fishman. Durham: Carolina Academic Press, 1993. Pp. xii, 316.

*Eric C. Bettelheim**

Professor Fishman's book is a useful and well-written survey of the "Big Bang" in financial services and its consequences for London. Not only is the style of the book lucid, essential in a work seeking to tell a complicated story in a manner that keeps the reader's attention, but he takes the important step of putting the events in the City of London of the last decade in their appropriate context, both historically and intellectually. Professor Fishman arrived in London in 1986, just as the Financial Services Act was coming into force. It was the century's turning point for the City. Neither the Great Fire nor the Blitz nor any other event in its prior history had the impact of that statute. It often takes a foreigner to have the perspective to see the longer term influences and the comparable developments elsewhere which locals miss, submerged as they are in the current of events. As a long time resident of London in a private legal practice advising financial institutions, and, like Professor Fishman, grounded in the American experience of the regulation of financial services, I was pleased to see confirmed by a comprehensive and objective study many of my own thoughts as to the key sources of difficulty and conflict wrought by the Financial Services Act of 1986. Such tensions were inevitable, as it was not only the first comprehensive statute establishing a regulatory system for financial services in the United Kingdom, it was an attempt at a revolutionary break with the past in a country whose very identity is tied to a sense of tradition and antithetical to rapid change.

Professor Fishman discovered that London is deeply influenced by its past — that it is, in fact, "a latter-day equivalent of a medieval market

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town for global money merchants.” He also realized that the story of the creation of the new constellation of regulatory bodies called for by the Act could only be understood in the context of the underlying economic, political and bureaucratic forces which combined to ignite the explosion. Given the breadth of this task, it is perhaps understandable that Professor Fishman could do no more than scratch the surface, as well as describe the basic elements of this brave new world, in 300 pages. For example, his examination of the role of each regulatory organization identifies key debates and issues, but the scope of his undertaking prevents real scrutiny of the events and personalities involved. No doubt others will follow in his footsteps in more detailed and perhaps even more profoundly revealing ways, but certainly he has established a useful framework for such analysis, both by scholars and by lawyers.

Although it is often hard for Americans to appreciate, the importance of London’s medieval tradition of regulation of trade by way of guilds and similar associations cannot be overstated in looking at contemporary developments. As Professor Fishman notes, the resistance to change, the cults of amateurism and exclusivity, and the suspicion of government are currents which run deep in the British tribal psyche, together with an instinctive preference for decisions to be made behind closed doors rather than in the full glare of public proceedings. The British are a discrete and reserved people, as well as a conservative people with a natural tendency to create “traditions” which may have the trappings of antiquity but in fact are of relatively recent vintage. The Scottish tartan, for example, was created in the mid-nineteenth century by an ambitious textile manufacturer and was certainly unknown to early Scottish history. By the same token, the tradition of self-regulation in the City, for all practical purposes, is little more than a century old, and its antecedents are not those of regulation at all but of trade associations devoted to promoting their self interest, not the public good. That the two goals were often confused is understandable, particularly in the context of the radical government of Mrs. Thatcher and the “greed is good” era; the same tendency leads towards capture of self-regulatory institutions by the industry they purport to regulate. The examination of this process by Professor Fishman reveals not only an aspect of the past but a warning as to the future of the so-called “self-regulating” bodies established since 1986.

The reluctance to rationalize such “traditional” institutions led to some of the most spectacular failures and to continuing vulnerability in the system established to regulate and promote the City as a financial center. For example, Professor Fishman makes extensive efforts to de-

scribe the much touted and wildly expensive proposal to modernize the Stock Exchange settlements system, known as "Taurus." I trust he was amused to hear that, since publication of his book, it was abandoned in its entirety at an estimated cost of £400 million. This was a perhaps predictable result of the management and leadership failures of the Stock Exchange and the inability of the City to displace archaic vested interests, such as registrars of companies and indeed the Stock Exchange itself, to achieve an end universally acknowledged as necessary to the continuing competitiveness of London as a financial center. Now the subject of further study by the Bank of England, the most recent promise is of a partial system which may be able to settle Stock Exchange transactions ten days after a trade takes place, and this only two years from now.

Similarly and of more lasting significance, the authorities have failed to successfully bring prosecutions in either major or minor frauds, no matter how egregious or damaging politically they may be. As Professor Fishman rightly observes, "the failure to obtain convictions of alleged commercial and securities violators publicly flaunts one of the new system's greatest weaknesses: the muddled organizational structure of overlapping and competing agencies."

That this muddle of at least six different prosecutorial authorities continues despite the embarrassments of Guinness, Blue Arrow, BCCI, the property futures scandal of the London commodities exchange (perhaps appropriately named at the time "London Fox"), and, most recently, the flight of Asil Nadir from prosecution over the collapse of Polly Peck, is itself scandalous. There is yet to be heard any proposal for fundamental reform or serious effort at consolidation of the various prosecutorial agencies. The muddle is likely to continue for years to come, to everyone's discredit.

It is with much irony that I recall the intense resistance of the City in the mid-1980's to an SEC being established in London. Professor Fishman's discussion of the financial community's reaction to the first rulebooks effectively conveys both the atmosphere of the period and the reactionary tone of the debate. Today it is almost the universal conclusion of leading City figures, as well as civil servants and regulators, that an SEC-type organization is exactly what is needed. Not only would it serve to consolidate and simplify the system, it might lend it some much needed credibility. One of the weaknesses which Professor Fishman perhaps missed, not having lived through the early days of the development of the FSA, was the apparent head-in-the-sand attitude of the leaders of the financial sector. Each was convinced that this legislative effort had little or nothing to do with them, and in any event would not apply to

their businesses in any significant way. The gap between the City and Government, which is no more than a mile as the crow flies, seemed unbridgeable in the early 1980's and was characterized by mutual suspicion and a failure to grasp the lessons of the past, particularly in the United States.

The City institutions' almost total lack of understanding of the processes of government and of public administration was worse than amateur; it was negligent. This was among the primary causes underlying Professor Fishman's observation of the late-in-the-day rush to implement the rules and to get the new self-regulatory organizations established, as well as of the resulting conflicts which the rush generated. The City has only itself to blame and I think it is wrong of Professor Fishman to shoot quite so often at the easy target of the Department of Trade & Industry (the DTI). In those days the DTI was the only entity, aside from Professor Gower's study group, which took the issue of modernization of financial regulation seriously. It was the only part of the civil service which made a serious attempt at consultation and self-education as it prepared the legislation. The City institutions, with very few exceptions, treated the Department's civil servants with contempt and hostility. They were rewarded by a statute which is in my view a remarkable achievement given the almost enforced isolation in which the Department had to work. By the same token, the Department had previously not been given the resources nor the personnel by any government to vigorously enforce the laws that the FSA replaced. The Government under Mrs. Thatcher was preoccupied with stimulating the entrepreneurial spirit and sense of enterprise which had so badly deteriorated under the long decades of consensus over the welfare state and was reluctant to threaten that effort with zealous enforcement of company law. The UK Treasury, preoccupied as it was with issues of high policy such as privatization, treated the DTI with comparable disdain while the Act was being fashioned. Ironically, last year the Treasury, belatedly realizing the DTI's importance, insisted that the Department's financial regulatory functions be moved to the Treasury.

What was also remarkable, and unfortunately only briefly adverted to in the book, was the blindness of the leaders of the City, particularly of the Stock Exchange, to the necessary implications of the breakdown of a fixed commission structure. Its logical consequences of industry consolidation, the need for significantly increased capital for brokers and other participants, the increased pressure on back-office systems, and the accelerated differentiation of professional from private investors, were all unanticipated. It is all the more remarkable, given that it was only ten

years before, on May Day, that the New York Stock Exchange and its broker members had gone through exactly the same experience, with just these results. It was with some incredulity that I watched the London Stock Exchange not only become the first one dominated in its governing structure by foreign entities, but as it succeeded, during one of the longest bull markets of the post-war period, in devaluing its seats to the point where they only represented a payment of £10,000 to members when they turned sixty years of age. This was at a time when the seat prices on the New York Stock Exchange, not to mention the burgeoning derivative exchanges in Chicago and elsewhere, were skyrocketing. This was not the result of some clever conspiracy, nor of the astuteness of the staff at the Bank of England or anywhere in the City establishment. It was the result of a stubborn refusal to believe that the laws of economics which operated elsewhere would operate in what until then had been a cozy cartel.

This was true of other institutions as well. For example, while Professor Fishman brings a much needed objectivity to this fascinating story, he, like others before him, is seduced by the mythology and exaggerates the abilities of the Bank of England. Its much admired “nod and wink” method of regulation is necessitated by its essential weaknesses. Indeed, the chief initial impact of the introduction of the FSA was to exclude the Bank from many of its traditional areas of jurisdiction. The Bank’s weaknesses are partly the result of statute and partly a result of its quasi-independent status, subject as it is to Treasury oversight. In the wake of its mishandling of BCCI and its continuing failure to achieve independence from government, it is highly unlikely that the Bank can take on the broad regulatory role which Professor Fishman recommends. Indeed, it would now both be too radical by far for the City to entirely abandon the new regulatory structure and contrary to the European trend. While it is true, as Professor Fishman observes, that securities markets had been subject to central bank regulation in many of the continental European countries, the tendency in Europe now is to separate securities regulation. France has recently established an independent agency for the purpose and Germany plans the establishment of a securities commission modelled on the SEC. In Holland and Italy too, securities commissions have been created, separate from the Treasury Ministries and the Central Banks. There is a growing recognition throughout Europe that central bank regulation is not appropriate, and indeed is not desired by central bankers, as it would involve them in the micro-management of financial products and marketing.

In contrast, another of Professor Fishman’s recommendations is

gradually being realized. Further consolidation of the self-regulatory organizations in the UK is going forward, and the proposed Personal Investments Authority is likely to assume the roles hitherto played by two of the original self-regulatory organizations focused on retail products. This attempt to institutionalize the difference between private and professional markets does have some theoretical attraction but the increasing role of intermediation between the private and professional markets played by pension funds and insurance companies may make that distinction harder and harder to realize in practice. The PIA is probably not a permanent solution, but yet another way station in the transition to a single regulatory authority.

In respect to private clients, I believe Professor Fishman confuses the approach taken by the UK regulators in respect to private investors with the US experience. In the UK it is not, as he suggests, a policy of disclosure but rather a fundamental policy of paternalism which has pervaded and bedevilled the regulations throughout their implementation. Detailed rules as to type of investment, diversification, leverage, valuation and trading, discourage innovation even when clearly in the customer's interest. The notion that unit trusts, the UK equivalent of mutual funds, and life insurance products, as presently structured and sold, are appropriate for the general public, has been discredited time and time again without penetrating the regulators' consciousness. Even in the wake of the most recent review of the regulatory system carried out by Andrew Large, now Chairman of the Securities & Investments Board, and by the Office of Fair Trading, it is evident that full disclosure continues to be successfully resisted by the retail sector of the industry. The real track record of products for the retail market is a dismal one if examined both from a point of view of return to the investor and the means by which private investment is attracted to them. There is little sign that this will be revolutionized in the near future. There is not even agreement as to a common standard of performance results, thus precluding comparative shopping by investors. A symptom of the failure of collective investments as structured in the UK, is the burgeoning growth of offshore funds which attract investors to unregulated environments. This trend is likely to continue, particularly as investment products become more widely available throughout the EC. The nursery notion that nanny knows best is hard to eradicate in the UK.

Perhaps of greater importance to readers of this journal, and an area which Professor Fishman does not deal with in any detail, is the failure of the commercial law and the courts to come to grips with the requirements of the professional markets in financial instruments. On the two

most recent occasions that major problems in professional markets have reached the highest court, the House of Lords, the judges both there and below have almost uniformly failed to understand or adapt the law to the changes which have occurred in the last decade. The first of these was the Tin Crisis on the London Metal Exchange, which essentially bankrupted the entire market as a result of the default of the International Tin Council to meet its obligations, and more recently and more spectacularly the Hammersmith & Fulham case, in which the courts held that local governments in the UK did not have the power to enter into swaps and other over-the-counter transactions in their efforts to manage their debts. In the one case the courts deferred to restrictive doctrine to excuse their powerlessness in the face of international treaty organizations, and in the other to a literal reading of statutes enacted long before these markets developed.

This does not bode well for the now favored distinction between professional and private markets, either in regulatory or public law. Both the tendency to over-regulate the financial markets and to resolve disputes behind closed doors are signs of just how immature the system really is. The resistance of the City to the need for a constructive relationship with government and regulators, and to the need for enlightened acceptance of the inevitability of greater legal intrusion into their affairs has helped to perpetuate this immaturity. Few if any senior practitioners have found the time or feel that the effort is sufficiently worthwhile to participate in a constructive way in the development of regulations, in the governance of the self-regulatory organizations, or the support of trade associations in making considered and balanced submissions to the rule-making or the legislative process. It was noted even as the Financial Services Bill was going through Parliament that it was the compliance officers of US firms and American lawyers who made the greatest input into the consultative and legislative process, recognizing as they did from their home experience how important such efforts were.

The regulators do not help the process by refusing to provide no-action advice or to build up a system of regulatory precedents, so terrified are they of getting it wrong. By the same token, the English judges' conservatism and lack of familiarity, both with financial markets and with white collar crime, continue to eat away at the legitimacy of the system in both the public's and practitioners' eyes. That the recent regulatory review, combined with the weakness of the present government, has again wasted an opportunity for the City to overhaul itself once and for all and to modernize its institutions, is a perfect example of the English muddling through; or, at best, a kind of half-hearted pragmatism. In-

stead of grasping the nettle and centralizing the regulatory and prosecutorial functions in a single entity, the plan proposes firmer oversight of SRO staff to ensure that they are doing their job. This cannot be the path either to future competitiveness or to an increased sense of confidence on the part of the investing public.

Time and experience will no doubt improve the efficiency and the effectiveness of the UK regulatory system for financial services. Perhaps the next scandal will push it into a stable and workable form. One can, however, be forgiven for wondering whether in historical terms the effort will be seen to have been worthwhile, given the increasing centralization of the European Community and the likelihood that before the century is out serious proposals will be entertained for a European Securities Commission. Given the US system as a precedent, was it really necessary to reinvent the wheel? If nothing else, the UK revolution in regulation, and its repeated revisions of rules and structures, has provided a fascinating laboratory for testing various models of regulation. As new financial centers develop in the wake of the spread of capitalism, one can only hope that the emerging markets and European Community will learn from the UK experience and not make the same mistakes.

Nevertheless, the fact remains that the Financial Services Act is a vast improvement over what went before, and as the new regulatory universe it created cools down, it will be seen to have been a necessary adaptation to the fundamental forces which the computer age has brought to financial services. The Brits deserve credit for the courage that they have shown in seeking to regulate the entire range of financial products under a single statute and to create a wholly new system in a very short time. Whether the effort was cost effective is another matter. One can only hope that they eventually adopt the lessons of the Chicago School of economics and learn to evaluate the costs and benefits of regulations before they are implemented. This and other issues remain questions for the future. For those of us who lived through Big Bang and its after-shocks, Professor Fishman's book is a useful aide memoire, and for those coming to it for the first time, either as an object of study or a context in which to work as a professional or layman, he has written the best introduction so far.