CONTROLS AND THE MOBILISATION OF CAPITAL

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Being a newcomer to this country from both a personal and corporate standpoint, it is perhaps presumptuous of me to address you on local matters, however, the question of mobilising and controlling other peoples money is most certainly an international one. This question and its concomitant feature, conflict of interest, is also perhaps a most timely topic. I wish to insert here some sort of disclaimer statement. Dr. Rae and previously Magnus Cormack in their talks, have stated, that they were speaking personally and not behalf of the Senate Committee on Securities and Exchange. Similarly, I should absolve my associates at Merrill Lynch in New York who, being some 12,000 miles away, would probably appreciate a degree of insulation from my personal remarks today.

I would like to establish my credentials to talk on the control in the financial industry. I have spent my entire business life in it. Upon completion of my years at the University, I joined a commercial banking organisation in the United States, where I spent 8 years in what American bankers consider to be the most highly regulated industry in the U.S. That bank was regulated by the State Banking Commission of Illinois, also by the U.S. Comptroller of the Currency, and as a member of the Federal Reserve System, the Federal Reserve Bank maintained its control of the banks operation. This bank in its various commercial activities was also subject to a variety of federal and state laws covering its Trust Investment business and its operations in consumer credit. Now as a listed public company, it is subject to further controls under the requirements of the New York Stock Exchange and the Securities and Exchange Commission on new offerings of its securities to the public.

Later, when I joined Merrill Lynch in the U.S. I became more closely acquainted with the S.E.C., the Stock Exchange and the National Association of Securities Dealers.

In the U.K., where I recently spent four years, Merrill Lynch was additionally subject to the Exchange control and other measures imposed by the Bank of England, as well as the Board of Trade which then regulate firms in the securities industry in London. Despite these years of business in a highly complex regulatory atmosphere, I stand here before you relatively unscathed.

While I was preparing these remarks I was unable to locate one of my favourite books which was published in the United States late in the 60's, entitled "The History of Financial Panics in the United States". The book rather clearly documents the major panics in U.S. commercial history. These collapses have occurred sporadically throughout our history. There is an interesting similarity between these episodes which are not difficult to recognise. They all came after a period of great optimism in the country. Foreign investment had been flowing in at a rapid pace. Speculation was rife in the share markets and real estate. New and unproven financial houses were assuming substantial roles in the community and then something happened. The buying pressure was gone and prices broke: buyers, those few with cash available stood aside and the few bold ones that stepped into the market found their investments dramatically lower within a short period of time. Any student of the 1929 debacle can recall the efforts J.P. Morgan and Company in consortium with the New York Banks who put together millions to stabilise the market. Not even the leading firms could stem the tide.

Intermingled with these panics, and during happier times, great personal and corporate fortunes were amassed with a rather blatent disregard for what we would now consider minimal commercial ethics.

The railroads were built and later encountered financial difficulties. Banks failed and perhaps the only economic experiences that Uncle Sam has missed during his maturing years have been an absolute loss of confidence in currency and the devastation of war.

During this period, a body of common law was slowly built up, reflecting the moral and ethical demands of the community, and finally acts were passed by Congress to establish the Federal Reserve System and the Securities and Exchange Commission, the two major regulators of the financial community. As Senator Rae pointed out in his talk in Melbourne two weeks ago, this history must be viewed in light of the fact that when 24 brokers met under the buttonwood tree in New York in 1792 to found what has become The New York Stock Exchange, Australia was a four year old settlement.

I believe it would be fair to say that the Australian Exchanges were rather provincial until relatively recent years. The development of Sydney with the influx of international financial firms from almost every major country in the world has come about only within the last few years. The diversity and numbers of organisations in the financial services industry surprises even those of us who are members of the community.

Similarly, the amount of overseas interest in the share market and in direct investment in Australia has shown that it can grow to almost overwhelming proportions. Day to day fluctuations of certain mineral shares at times depended upon what was being said and done in London - not in Melbourne, Sydney or even Kalgoorlie. The U.S. as well, went through periods when large amounts of foreign capital were used to finance local development. As a matter of fact the Chicago and Northwestern Railroad, one of the major links in the U.S. transcontinental system, was, so the story goes, financed by U.K. money and designed by English engineers. The only drawback is that to this day, all through trains travelling over the Northwestern system must cross over to the other side of the tracks for the Northwestern is the only U.S. railroad that runs on the left hand side of the road.

Nevertheless, having had this background in mind when I arrived here earlier this year, I was somewhat surprised by the concern expressed in certain areas of the financial community about the Federal Government enquiries into the securities industry and the possibility of a standing supervisory body to oversee and regulate the securities markets. My message to you today is that outside control of the securities industry will not hamstring your every operation and, in fact, it should improve the scope, and in time, the profitability of responsible firms in the industry.

As happens periodically, in every stock market, we are going through a period of agonising reappraisal. As an associate once said in London "The market is aggressively seeking support - at lower levels".

Stock Exchanges, client advisors and professional investment managers are seldom viewed with great favour at times such as we are currently experiencing. The Government, the press and, in fact, the man in the street is taking more than a passing interest in the inner workings of the markets. The names Taxminex, Minsec, Antimony Nickel, Leopold and other developments come too quickly to mind. The bear market and the notoriety which has accrued to the Stock Exchange, and more broadly, the investment community, comprise the elements of change which are coming to hand and it behoves us all to do what we can to see that progress is made on a constructive and workable basis. I would like to point out that it is difficult to assist in the formulation of new policies while in opposition and I commend the leaders of the industry who are speaking out in favour of Australian Federal control to provide investor protection.

During my preparation, I came across this comment which is worthy of mention - "The public interest dictates that the primary purpose of a securities market is to raise capital to finance the economy. Without continuous capital formation, our economy could not grow or prosper. It could not provide job opportunities for our growing labour force. It could not sustain a rising standard of living. It could not generate economic opportunities so vital to the health of our free enterprise system. It could not assist government in its programs to lessen social problems such as poverty, and crime. By contributing to the mobilisation of capital, a stock exchange serves the entire population.

"In fulfilling this principal role, a stock exchange must also serve those who have already committed their capital to finance the economy. It must enable them to reconvert their securities into cash whenever their needs required. Investor confidence in the ability to resell securities on fair terms is critical."

This is not a quote from an economic text book. It does, however, have a lasting sort of quality, and one could easily mistake it for the type of comment which we hear more and more frequently here in Australia. It appears to me, that some of us here in Australia, feel we have a unique local problem as a result of our nearness to the South Pole. The statement was not from Alexander Hamilton nor Maynard Keynes. It was from a paper dated slightly over a month ago, on August 5th, by William McChesney Martin, the past Chairman of the Federal Reserve system submitted to the Board of Governors of the New York Stock Exchange. The problems of today are not unique to Australia, nor are they a new phenomenon in the world. They are obviously part of a continuing and unending evolution.

I must add, however, that I do not believe controls are likely to lead us to Utopian Capitalism. Conflicts of interest, for instance, cannot be done away with. Responsibility for the management or handling of other peoples money must be placed in the hands of those who can properly resolve their conflicts. I offer you a brief quotation from a speech by Don Regan, the Chairman of Merrill Lynch, Pierce, Fenner and Smith of New York -

> "A life without potential conflict in our inter-related business world is like a business without risk - impossible to legislate and of doubtful wisdom if possible. Politicians live perpetually with conflict - between the public interest and the desire for re-election. When one senator in the U.S., pure in spirit, voted as his conscience dictated, even though he knew it would jeopardise his chances of being re-elected, the act was considered selfless enough to warrant him a full chapter in John F. Kennedy's "Profiles of Courage". If you will look elsewhere, newspapers and magazines and television presumed exquisitely objective in their editorial judgements, are dependent on advertisers for the revenues that enable them to publish and to profit. We cannot build a wall against every foible, against every unethical act or we would be forever immobilised. Obviously we need standards of conduct to cover this aspect of the securities industry as we need standards for politicians and the news media. An easy platitude says that a man cannot serve two masters - I say that in modern corporate life, a man who cannot serve two, is unlikely to be hired by either".

In the United States most of the major securities underwriting houses are also highly active in stock-brokerage and deal from their own book in the over the counter market for unlisted issues. These conflicts are with us all the time - but due to the controls the system works in a highly acceptable manner.

Federal or Commonwealth regulation however, must be the court of last resort in terms for investor protection. Certainly it should provide among other things an accepted code of conduct to guide the day to day business of the industry. But legislation or regulation should not be expected to eradicate stupidity or dishonesty. We have had and most certainly will continue to have, occasional failures of securities firms in the U.S. and we will experience industrial bankruptcies, but those of us in the financial industry will know just what is required of us and the public will know that safeguards are there for the protection of both institutional and individual investors. While the existing controls in the U.S. have not caused the development of a perfect market, I hesitate to think of what the U.S. capital markets would be like in the absence of federal control. As a minimum, I would expect that the stock and bond markets in the States would be much thinner and more volatile but for the presence of regulation.

Uniform principles provided by federal supervision provide one basis for the most important form of industry control, that being self control. I am talking of a firms control of its own individual operations, its employees and its clients. An individual firm in the industry, be it a broker, a merchant bank or an institutional investor, must have a framework of internal laws or policies, as they are known in corporate jargon. These laws are set down by the Board of Directors or the senior management and normally carry certain sanctions to encourage adherence to firm policy. These policies are most effective when regularly reviewed and circulated. No matter how thorough an original policy might be market conditions or technical innovation can outdate the finest of management directives.

One of my colleagues was interested in a Policy Bulletin from Merrill Lynch in New York on my desk recently, entitled "The Spirit of 48". The policy flows from a basic credo that the customers interest must come first - which prohibits employees from acting on Research Department recommendations until two days after publication.

It reads, in part " ....
Effective immediately:

1. All Research Reports are included in the policy whether or not a change of opinion is involved.

2. Technical suggestions, made by technical market analysis via the scheduled weekly conference call, are subject to the 48 Hour Rule.

3. Printed material which represents a follow-up to Research Reports which have previously appeared on the newswire are <u>not</u> subject to the 48 Hour Rule with the following exception. When the Research Division publishes booklets on special topics, a one week rule will apply from the original date that the newswire announces what securities will be covered in the booklet.

4. Any additions or deletions of securities from current selections, long term selections, and income selections are subject to the "48 Hour Rule".

5. Purchases or Sales by employees will be permitted starting exactly 48 hours from the time of the transmission of the material over the newswire.

6. Employees will be defined for the purpose of this rule as employees, spouses, or dependent relatives ... "

This policy seems to cover the matter rather clearly.

I hope that the sighting of this particular item has not obscured the basic policy of "the customer's interest must come first". Individual firms can police their own operations but they cannot set standards or supervise the business of their competitors.

The Stock Exchange or exchanges can play a major role here, but there are limitations as its jurisdiction can cover only its own membership and to a certain degree the companies listed on the exchange. Stock exchange self control will always be subjected to a credibility gap in the eyes of the public due to the in-house nature of its committees. Additionally, here in Australia, the difference between the requirements of the various Australian stock exchanges and the applicable local state laws is likely to be confusing to the investor, be he domestic or foreign.

The stock exchanges obviously have the best working knowledge of their own business and they are most advantageously placed to provide sanctions in the areas of the industry over which they have logical jurisdiction. The unfortunate problem is that the exchanges get blamed occasionally for breaches of moral or ethical codes by parties or circumstances outside of their control. This is another gap that can be covered through adequate federal regulation.

The establishment of a standing body on the securities industry should also provide a greater knowledge of the financial community in the government thereby providing for enlightened and well devised new legislation. For example, in lieu of adequate investor protection, Australian law still relies upon the unlimited liability feature of mutual fund companies. Surely unlimited liability is something left over from the dark ages. Legislative control of mutual funds sales and operation could provide much greater public protection than is given by this feature of company law. Just who is protected by the unlimited liability feature of a mutual fund? I would have to say that this feature provides protection for the fund's creditors, its brokers and bankers, perhaps at the expense of the public.

Similarly, the lack of adequate controls has a disruptive effect upon market practices. Short selling is a case in point. Personally, I do not see anything sinister in short sales per se when conducted under adequate controls and supervision. The short sale provides liquidity to the market and at times can be used to reduce risk. It is not exclusively a speculative tool. Short sales on the New York Stock Exchange must be designated as such thereby allowing the exchange to keep track of the short position in an individual issue. Should the short position become unduly large in relation to the floating supply of shares, the Exchange announces that future short sales are temporarily banned and total short positions are reported to the public on a regular basis. Additionally, short sales may not be made on a down tic. That is to say, that the short sale may not be made at a price lower than the previous sale, thereby acting only as a stabilising force in a rising market. Nevertheless, the short must be used with discretion and restricted to sophisticated accounts. There is still some validity in the saying "He who sells what isn't his'n must buy it back or go to prison".

Having dealt with conflicts of interest in the brokerage community, mutual funds and short selling, I should perhaps comment upon full disclosure and insider trading. I would like to state without equivocation that I am in favour of the former and against the latter. I also am in favour of motherhood, patriotism and the five day week. In all seriousness, I mean it that strongly. Capital markets, to fulfill their economic potential to a community must be adequately informed of significant developments in order to maintain a realistic balance. Insider trading profits destroy public confidence and adversely reflect upon the company involved as an entity to the detriment of the other shareholders.

It must be admitted that government controls often fuel the fires of bureaucracy, but a properly constructed and administered body need not get out of hand.

You may ask what is the greatest practical advantage. I suppose I would have to return to the often used term "investor confidence" and the many ultimate benefits flowing from this development.

Investor confidence in the Australian share market has been badly shaken both here and abroad. As Mr. Arvi Parbo of Western Mining Corporation told you at your last meeting, the real mining boom has only started. In other circumstances there would be good reasons to expect a rapid return of interest to equity investment in the dramatically expanding mineral sector, but without fundamental changes in the market for these equities, the recovery of confidence may be slow and laborious. The nature of many Australian projects require the mobilisation of massive amounts of capital. If Australia is to provide a more significant proportion of the monies required for future development, public confidence based upon workable safeguards must be developed. In addition, the foreign investor will continue to be hesitant as long as local markets remain thin and public participation in the equity market is limited.