

'A STOCK EXCHANGE VIEW ON SECURITIES INDUSTRY LEGISLATION'

An edited text of a luncheon address given by **Mr. W. A. Park**,
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In advancing a Stock Exchange view on Securities Industry Legislation, my comments largely relate to The Brisbane Stock Exchange although in general they apply to the industry as a whole.

To begin with, it is essential we have regard to the history and record of the industry. The Brisbane Stock Exchange has been operating for about ninety years and some of our member firms have been trading for almost as long as that — second and third generations of share brokers are not unusual. For most of this time, there was no specific legislation relating to the industry, and because of this, Stock Exchange rules and regulations were the means by which listing of companies and trading of shares was regulated. They still are, because in Australia, legislation is almost non-existent and it is custom and usage in the industry which provides the de facto law. So while critics may have a field day on the failure of some of the self-regulatory rules, it is pertinent to remark that without self-regulatory rules, there would have been no rules at all. Also one wonders, if there had been legislative rules, whether they would have stood the test of booms and depression even as well as the self-regulatory rules. Experience in the U.S.A. with its S.E.C. legislation since the 1930's, doesn't encourage a blind faith in legislation. It still didn't prevent the collapses in the late 1960's in that country.

Our industry was and still is based on trust — where a word is a contract. This applies between broker and broker as well as between broker and client. The industry cannot work efficiently any other way, but, of course it is susceptible to breakdowns when someone abuses that trust.

The point I wish to emphasise is that the system did work over many years. No one can stay in business for long unless he has a record of honesty and fair dealing with clients.

There are many honourable and honest sharebrokers. The Rae Report had this to say: "The Committee wishes to make clear that in the course of its inquiries, it also found members of Stock Exchanges who did maintain high standards of integrity in running their firms. In addition we received guidance and assistance from members of Stock Exchanges who have been concerned about certain practices in the market and departures from ethical standards".

Well, what went wrong with the self-regulatory system? The Rae Report said "in the first place, it is

in circumstances when the market is busy, that the willingness of the various market institutions and firms to meet their public responsibilities is tested, for it is then that the opportunities for abuse and the adoption of low standards are more readily available". To this could be added that when the market becomes busier, the work load tends to increase disproportionately and overwhelm the staffing resources. Few people realise the volatility of market volume, even from one day to another, and the consequent difficulties of staffing, having some regard to economics. In a nutshell, the nickel boom of 1968-1970 and its later collapse, tested the system, and unfortunately found it deficient in some areas. But before we become too critical, we should remember that this was one of the major booms in Australia's history — to quote the Rae Report "The evidence reveals a picture of a market distorted by a degree of speculation that may rank with the excesses of earlier booms in Australia's history". Not only stockbrokers were involved, but company promoters, directors, geologists and let us be frank, the greed of many people.

Most people are not aware of the magnitude of the boom and its impact on the securities industry. I quote some figures from the Rae Report.

Reported sales on four exchanges were \$500-\$600 million in each year 1966 & 1967, which the Rae Report recognised as normal years, sales peaked at \$3,400 million in 1970, and fell back abruptly after that.

249 new companies were floated in the boom (1968-1971) 184 of them underwritten by Stock Exchange firms. (There were about 1200 companies listed before the boom).

Increases of such magnitude overwhelmed the human and equipment resources in the industry — just as another boom of the same relative magnitude would do today. In fact, the breakdown would be worse, because of further work loads imposed by Securities Industry legislation introduced since the boom.

In the midst of all this turmoil, the senate decided in March 1970 to set up a Committee of Enquiry — it first met in April 1970 and finally

tabled its report in July 1974. The Rae Report, although it is not the bible which some people seem to think it is, served a very useful purpose. People generally, and the great majority of sharebrokers were appalled at the disclosures. Action was taken by Stock Exchanges to tighten up rules and regulations and many of these changes were in operation before the Rae Report was published. Unfortunately, the Rae Report does not perhaps give sufficient acknowledgment of this fact.

Meanwhile the State Regulatory Authorities decided that they would legislate in certain areas, hence the Securities Industry Act of 1971. The Queensland Act was similar to but not identical with other States. There was little consultation with the Securities Industry at the time.

The whole ballgame changed in December 1972 because the new Federal Government had a totally different philosophy. It was convinced that there was no place in the future for Stock Exchanges (the first Treasurer told us so), and it was committed to a policy of complete control of the free enterprise system. It aimed to eliminate the private sector by choking it to death. Hence the Corporations and Securities Industry Bill — work on it was commenced long before the Rae Report was published. There was no attempt to introduce good workable legislation which would improve the protection to the public and the efficiency of the system; Rather the objective was to set up a gigantic bureaucratic organisation to control every aspect of corporate and securities activities.

We had long and detailed discussions with Canberra at public service level, but on all major matters we were told these were political decisions and were not for discussion. We never did get to discuss them with anyone. The drafting of the C.S.I. Bill was largely completed before the Rae Report was issued, but of course its publication gave the Government some semblance of a reason for later introducing its far-reaching legislation.

The C.S.I. Bill was pushed through the House of Representatives (it was a possible double dissolution bill) but was deferred in the Senate. The senate set up another committee to look into the bill under the chairmanship of Senator Georges. This committee did a lot of work — and its report would have been very interesting indeed. I can only speculate on what it might have contained, because as you know there was a change in Government last year, and the committee has not been reconstituted. However, from our discussions it seemed to us that the committee was becoming aware of the enormity of the implications of the C.S.I. Bill. One example — it was estimated that the annual cost of the proposed S.E.C. in Australia with a staff of 400-600 (in 1974) would have been the order of \$10 million a year. (Or more than 3 times the cost of running all

the Stock Exchanges in Australia). By comparison, the U.S. S.E.C. in 1974 cost about US\$36 million — for a country almost 20 times bigger than Australia. Also I doubt whether the constitutional problems were fully appreciated by the politicians until the Georges Senate Committee was appraised of the problem.

Meanwhile in mid 1975, four of the states (non Labour Governments) banded together in a last ditch attempt to pre-empt the Federal C.S.I. legislation. Those states introduced a Securities Industry Bill in October last year which was passed by all four states in about six weeks. The Stock Exchange was not consulted at any stage before the Bill was introduced. We were aware a bill was being drafted and requested consultation. This was denied. Certainly we had discussions after the bill was introduced, but by then the legislation had been largely determined and agreed to by four states. There was insufficient time to peruse, discuss and amend the legislation because the State Governments were most anxious to get some legislation on the books.

Although the Act was passed last year, it was not operative until 1st March this year because of the difficulties encountered in drafting the regulations. Again we were not really consulted, although most of the sting in the legislation especially in regard to licensing, annual accounts etc. is in the regulations.

The 1975 Act was drafted in haste and is a hybrid of the old act and some sections of the C.S.I. Bill. It certainly (and thankfully) omitted the worst features of the Federal legislation, but has a number of matters which are unclear to say the least. Worse still it contains sections with which we believe it is impossible to comply. In some instances the answer given to our queries or protests was that the legislation was there to catch the offender, not the person who made an innocent mistake — that the section would not be applied to such a case — or that it was difficult to prove such an offence, and not to worry.

Hence to date, we sadly realise that there has been no sign of any genuine attempt to introduce good securities industry legislation. There has been no attempt to take an overall look at the industry — rather a bit has been imported from other legislation, or from outside Australia, or may be even from some bureaucratic brainchild, to try to solve one problem without due regard to the overall picture. There have been no meaningful discussions with the industry on proposed legislation. It has been presented largely fait accompli and then we have the task of trying to make it work.

Our greatest problem is finding people on the government side who have a working knowledge of the industry. The Rae Report was somewhat critical of the State Offices and stressed the importance of

the Commission having "or its staff some persons who have experience and understanding of corporate affairs and the securities industry". I regret to say that this is still not so. Thus it is difficult for those charged with regulating the industry to understand our point of view which is intensely frustrating.

Having said that, I must in all fairness say that in recent months in Queensland there have been signs of an improved knowledge and understanding of our work — certainly there have been more discussions with the Commissioner's Office than before and maybe out of these will come a better understanding by both parties of each others problems.

Well, let us turn to some specific examples.

Stockbroker/Sharebroker

Section 117 of the Act prohibits the use of this title by other than a member of a Stock Exchange. However, when we complained about entries in the telephone book which seemed to us to offend Section 117, we were told that nothing could or would be done about it. Yet we were also told that some of our members cannot describe themselves as stockbrokers unless they take out a dealers licence even though they are consultants or employees of a firm and would normally hold a dealers representatives licence.

Licensing

Our members, our operators, our branch managers must be licenced — fair enough. We also need to licence anyone on the staff who may give investment advice — for example, private secretaries etc.

Yet banks and bank managers do not need a licence to give investment advice.

Audit Reports

Section 65 of the Act requires an auditor to report to the commission on certain matters including any matter which constitutes or may constitute a breach of Sections 57, 58 and 60 of the Act (these Sections refer to dealers accounts and records, security documents and trust accounts).

Every breach or **possible** breach must be reported to the commission — there is no provision for materiality. In fact our request for such provisions was refused. The result is going to be greatly increased audit costs if auditors carry out the strict letter of the law, whilst the effect on our staff morale and work output when every error, no matter how minor, must be reported to the commissioner (and no doubt investigated) may be disastrous. Staff can't be blamed if they concentrate on not making mistakes rather than getting the job done.

The form of the audit report contained in the regulations is such that I have been told that no auditor can sign it without qualification.

Trust Accounts

There was an article in the Financial Review headed "The tangled state of Brokers Trust Accounts". We say "Amen".

Probably nothing in the history of securities industry legislation in this country has caused so much trouble, so much work and so little protection to the public. No other major country in the world has the legal type trust account to the extent that it has been imposed in Australia — in fact in the U.S.A. and Canada they state quite bluntly that trust accounts as laid down in our legislation just won't work and what is more, deprives the industry of a legitimate source of working capital.

Now this a very vexed and complex problem and could be the subject of much discussion. So I can't possibly do more than touch on it here. Trust accounts have an emotive sound for politicians and the public, yet the facts are that true trust monies in this industry are relatively small in amount. The legislators have endeavoured to overcome this by deeming to be trust monies, funds which we regard (and I would suggest most commercial people would agree) as normal business transactions. We do not object to true trust accounts, but we do reject the legislative approach which, by regarding most transactions as trust type transactions, impose a great deal of additional detailed work on the industry, and in the end don't really give proper protection to the public. In fact, we maintain that it is impossible to comply with the Act.

Perhaps one way to convey to you our problems is to give you an illustration of the effects of our trust account legislation if applied to other businesses. I am not saying that they are legally the same — I quote them so that you can see our bookkeeping problems — in addition to all our normal accounting and scrip recording.

Example

I buy an airline ticket to some distant destination with stopovers on the way. The money I pay to the airline should be paid into a trust account — part withdrawn into the general bank account when I arrive at stopover A, part at stopover B and so on.

Or to take a more advanced example, I have the cost of my airline ticket debited to my account. When my account is paid to the airline, I am still overseas and have not completed all the flights. The airline, when it receives payment of my account should pay the whole amount into trust account — then withdraw the cost of the flights I have completed at the date of payment of the account, then as each subsequent flight (or part) was completed, withdraw from trust account the cost of that flight.

The Rae Report says "It must be recognised that the organisational problems faced by a busy broker

in maintaining a trust account are considerably different from those of a solicitor or a real estate agent”.

The Act gets itself into all sorts of tangles — or almost did. At the last minute, the 1975 Act was altered (Sec. 59) to overcome some problems only to create others. For example, the original draft of Sec. 59 stated that the dealer had to pay into a trust account all monies held by him in trust for a client. It went on to specify that all monies received by a dealer otherwise than in payment or part payment of a debt due to the dealer, shall be deemed to be held in trust for the client.

We argued that a debt must be due to the dealer at or about the time he issues the contract note because at that time he owes the selling broker. His records show client as a debtor, broker as a creditor. The client is in fact the owner of the securities at the date of the contract note and is entitled to all dividends, new issues etc. from that date (whether or not he has paid for the securities). If the client is the owner of the shares, the broker cannot be the owner. If the broker is not owed a debt then he is neither owner nor debtor. What entry does he make in his books? Every broker's accounts prepared to date would be wrong and all calculations of capital requirements based on debtors indebtedness etc. would be useless.

Also, if the debt is not due to the dealer at or about the time he issues the contract note, what about Section 61 which relates to auditors (the auditor cannot be indebted to the dealer for more than \$2,000) and Section 116 — dealings by employees (where a dealer cannot give credit to an employee for dealings). If, as some legal people argue, the debt is not due to a dealer until he, the dealer, has paid for the securities from the selling broker, then what is the purpose of Sections 61 and 116. The Rae Report specifically mentioned the problems which arose when employees of a dealer did not pay the dealer for shares until the dealer paid out on delivery, which often was months later. What also is the meaning of Section 58 (security of documents in the custody of the dealer) when it refers to “an amount owed to the dealer by the client”?

If, as we claim, the debt is due to the dealer on the issue of the contract note, then the monies involved are not trust monies and should not be subject to legal type trust account legislation.

In the end, the Securities Industry Bill was altered to avoid this problem of trust monies and debt due to the dealer but the alteration only compounded the problem. In Queensland and Western Australia the new Act does not yet apply.

We and the Western Australians were able to convince our Governments that the Act cannot be complied with and that pending a joint Govern-

mental Industry Committee to investigate the whole matter, we should each comply with the provisions of the old Act.

In essence our argument is that trust accounts as prescribed by the Act are impracticable and do not offer adequate protection to the public. It is ludicrous to impose detailed procedures on monies when negotiable scrip is completely ignored by the legislation. The industry should be freed of unnecessary detailed work and public protection obtained through adequate surveillance, audit procedures and fidelity funds.

Minimum Capital

It is ironical that Stock Exchanges were accused of being the preserve of the wealthy few by the retention of an outmoded and antidemocratic system of seats. Ironical because nearly all Stock Exchanges have abolished them and now we have legislation and licencing which will require a much higher capital from many stockbrokers than previously.

It is now more difficult than ever for young men of ability, with modest capital to enter the stockbroking industry. Legislators seem unable to understand that this sort of legislation will force out the smaller brokers — it will lead to fewer and larger firms and this is not in the public interest.

The stock market is an auction market and an auction market requires a number of buyers and sellers. If there are only a few buyers/sellers then it becomes a dealers market. Hence there is an important role for the smaller broker and legislators should not overlook this. There are grave dangers that the smaller brokers and the smaller exchanges will be forced out of business not by competition in the market place but by ill conceived legislation.

These are but a few of the problem areas in the Securities Industry legislation. Time does not permit me to give further examples in detail but I could briefly mention some other problem areas such as

Interests in securities	Sec. 5
Associated persons	Sec. 6
Disclosure of interests	Sec. 52

And as many of you will be aware

Insider trading	Sec. 112
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or even the problems of altering any rule of a Stock Exchange which now require I.C.A.C. approval (or the lack of veto) as well as in some cases Trade Practice Commission approval. You can imagine how long all that can take.

Perhaps you may ask, what should be done about it. My answer is that surely the way is for Governments and the industry to sit down together

with a genuine desire to have the best possible legislation and procedures — the best public protection with proper regard to the efficiency of the industry, the practicability of the procedures and the cost of all these protections.

Governments could lay down the basic outlines of what is wanted — the industry could suggest ways of achieving them. Discussion and understanding of each others viewpoints should lead to much better legislation.

Instead legislation has been thrust upon us — with impossible impracticable costly pinpricking requirements which do not achieve the publicly stated objective. It is not possible to legislate for honesty or morality. Attempts to do so only make it difficult and costly for the honest to carry on business and do not unduly hinder the dishonest.

I do not argue against Securities Industry legislation — of course it is necessary. But there are dangers of an overkill. There are dangers in imposing legislation which lays down fixed rules and regulations and which do not adapt with the times in this fast moving industry. There are dangers that legislation (which has difficulties in onus of proof) may drive out the self-regulatory aspects of a profession which, if properly carried out, can be much more

effective in the public interest. There are dangers in seeking uniformity for uniformities sake.

Having said that let me finally say that in recent weeks there have been some welcome moves in the I.C.A.C. states towards a much closer co-operation between Government and the Stock Exchanges. We hope that shortly there will be a joint working committee to examine some of the matters I have referred to.

If only all this had happened some years ago.

Since I prepared this address N.S.W. has announced it is withdrawing from I.C.A.C. It is now virtually certain that the Federal Government will introduce legislation and I guess we are resigned to the fact that yet again, and for the third time in three years, our industry is faced with the time consuming task of examining and adapting to new legislation. Hopefully we will be consulted in a meaningful way — hopefully there will be uniformity throughout Australia — hopefully it will be what all Australians want — good workable legislation which does more than just regulate (or strangulate) the industry — legislation which will improve protection to the public and to brokers and which will improve the efficiency of the whole system.

BOOK REVIEW

USEFUL NEW WORK ON AUSTRALIAN FINANCIAL SECTOR

This book presents an introductory analysis of the structure and operations of the financial system and a more detailed examination of the financial institutions in Australia.

In Part 1 a general review of the structure and operations of the financial system is given, with statistics of the structure and growth of the Australian financial sector.

Part 2 is concerned with a more extensive analysis of the various kinds of institutions which comprise the Australian financial sector. These institutions are of three broad kinds — money supply institutions, financial intermediaries, and agency institutions. The procedure adopted in the analysis is based on flow-of-funds analysis.

Part 3 gives an elementary evaluation of the Australian financial sector, first with respect to its general activities and then in terms of its operational and allocational efficiency. Finally, the performance of the financial sector is reviewed in terms of its importance in pursuing the goal of economic stability.

("The Economics of the Financial Sector", by C. P. Harris, Cheshire, Melbourne, 2nd ed. 1975, \$A6.95).

E.F.G.