NEGOTIATED BROKERAGE

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If you believe, as I do, that brokers play an important role as intermediaries in the financial scene then clearly this subject demands consideration well beyond the superficial concept of reduced costs.

While there has been some discussion in Australia about negotiated brokerage, as far as I am aware, there is no particular group actively proposing its introduction. Instead, I think that local discussion has been concerned primarily with what is regarded as inequity in the present scale of charges. For example, if a broker invites you to buy a parcel of stock which he holds, why should you be asked to pay an order fee if you accept his offer? One possible solution to many of these criticisms would be the introduction of negotiated brokerage rates on a similar basis to that operating in the United States. Clearly, the introduction of that system in the U.S. has focused attention on the system and led many to believe that it will ultimately be introduced by our Exchanges.

At this point I think it worthwhile considering briefly some of the events which were responsible for the introduction of negotiated brokerage in U.S.A. Not surprisingly perhaps, it had its origins in 1968, a time of great activity on the New York Stock Exchange. In April that year, the Department of Justice filed a document with the Securities Exchange Commission. Prior to this event the New York Stock Exchange had never been called upon to justify the enjoyment of a private price fixing arrangement at the heart of an open competitive economy. The Department of Justice urged the Securities Exchange Commission to inquire factually to determine whether price fixing was really necessary. In addition, this document invited consideration of the Exchange's view that regulation by the Securities Exchange Commission granted it immunity from the anti-trust laws. In 1963 the Supreme Court had ruled that immunity for the New York Stock Exchange "is to be regarded as implied only if necessary to make the Securities Act work and even then only to the minimum extent necessary." It is important to recognise that whatever immunity the Exchange enjoyed from anti-trust regulations, existed only because it was subjected to Securities Exchange Commission supervision of rates. It was the Securities Exchange Commission that was initially responsible for varying the earlier rate structure applied by the Exchange. Significantly this occurred first in the reduction of rates charged for large parcels of stock involving consideration in excess of $500,000. It is clear that the introduction of negotiated brokerage in U.S.A. occurred as a result of pressure exerted by the legislature and finally embodied in a statute.

I emphasise these features because, as far as I am aware, there are no similar statutory bodies in Australia capable of exercising that authority. However, the fixing of brokerage rates is subject to the Restrictive Trade Practices Act and I understand the Exchanges hold an authorisation for this and other practices falling within the ambit of the Act. That is not to suggest that a body will not be established in the future and have those powers conferred upon it, nor is it to suggest that it will never be mandatory to unfix brokerage charges. It is intended merely to underline the fact that brokerage rates are presently established on a fixed basis by agreement by the Exchanges. At the same time, the introduction of negotiated brokerage in one country alerts the legislators and Exchanges alike to the fact that it could occur here, either voluntarily or by direction.

There were other reasons which placed pressure upon the maintenance of old brokerage arrangements in the U.S.A. Until February 1971, the over the counter market was merely a loose informal network of participants connected by telephone plugged into NASDAQ — the National Association of Securities Dealers Automated Quotations. Using computer terminals, thousands of brokers, dealers and institutional investors who buy and sell stock were then linked together in an efficient manner. There was also the development of the so called third market which prised business away from the New York Stock Exchange. Finally some of the regional exchanges offered membership to institutional affiliates. These events all had the effect of fracturing business and helped develop the climate in which, as mentioned previously, legislation was later passed imposing negotiated brokerage rates. There was also some anti-trust litigation, which placed pressure upon Exchange practices.

Before discussing the merits of fixed brokerage compared with negotiated brokerage, I believe we should identify the various types of services which brokers provide. Any reduction in net income flowing from negotiated brokerage will almost inevitably result in a reduction in the range of services offered or in their quality or a combination of both.

The services offered by broking houses include:—

1. Acting as a buying or selling broker.

Apart from the requirement to act in his client's best interest, the broker is responsible for ensuring registration, collection of any dividends to which a buyer may be entitled but does not receive because of late registration, collection of bonus shares etc. Some of these services may appear to be of little moment, but are much appreciated by those who annually have to satisfy their auditors that they have received all dividends and scrip to which they are entitled.

2. Advice

Brokers are expected to be capable of giving advice to clients, consistent with the client's requirements, about all types of securities. In the case of debenture stock this calls for an understanding of the principal limitations of the trust deed as well as interest rates offered by securities which are otherwise comparable. Preference shares frequently call for a knowledge of the memorandum and articles of the issuing company.

These requirements are additional to the fundamental advice which a client often seeks as to when he should sell and when he should buy.

3. Corporate Advice

Many brokers offer underwriting services and general advice on funding, fund management etc. While fees for this type of service are separately arranged, I would expect that these charges are influenced by the level of income received from other sources.

4. Research

The detailed analysis of the operations of certain listed companies is undertaken by many firms. Some institutions rely more heavily than others upon this service, but it is clearly expensive and time consuming to provide a good standard of research material. Some firms extend this service to basic economic research to provide a background against which to highlight their company reviews.

I am sure that there are other facilities offered by various broking houses, but these four areas cover the broad range of activities. Let us look now at some of the arguments advanced in favour of negotiated brokerage rates.

These arguments are generally persuasive and not capable of being readily dismissed. Negotiated brokerage is seen as a means of promoting more active competition amongst broking firms, leading to innovation, efficiency and healthy change. It is claimed that it would result in charges being geared more directly to costs. There is no reason why firms which are heavily involved in the provision of research material, should not charge for that separately or expect their clients to pay brokerage charges which are sufficient to cover the dealing cost and the research cost. At the same time, firms anxious to provide mere order execution at lesser commission rates, could do so. It is my opinion that some advocates of negotiated brokerage believe it is likely to promote more mergers, particuarly amongst small to medium sized firms, which provide a full range of services, as they attempt to contain costs.

There are also many arguments advanced against negotiated brokerage. It is seen as a threat to the professional status of the industry, driving commission rates down and thus resulting in an overall reduction in the range and quality of services offered. It is claimed that strong firms may cut brokerage rates heavily simply as a means, short term, of driving weaker or smaller firms out of the industry. From the viewpoint of the financial community as a whole, this should be viewed with alarm, as it will inevitably result in loss of liquidity within broking houses and therefore increase risk of failures of firms. It is also claimed that negotiated brokerage rates would result in discrimination against the small investor. He may well be called upon to pay higher brokerage costs to offset the lower payments sought from institutions.

Against this background, it is my intention now to look at some of the U.S. experience of negotiated brokerage following its introduction on 1 May 1975, now almost two years ago.

One of the major problems was the greater difficulty which traders had in being able to defend themselves against any allegation that they had failed to meet their primary obligation of executing an order to the best advantage of the client. There was no definition of "best execution" which embodied price and brokerage. At the same time, they knew that, as traders, they were liable to suit if, with the benefit of hindsight, a client ascertained that the transaction could have been concluded on a more advantageous overall basis.

If a thinly traded stock were available at a satisfactory price, was the dealer obliged to try to obtain the stock elsewhere at the same price with lower brokerage rates before concluding the transaction? If he did so and then found when he went back to the original seller or buyer that the stock was sold, what then was his position? This problem was not new, but it was further complicated by the introduction of variable brokerage rates. In some instances, institutions commenced keeping better records of negotiated trades to enable them to respond more effectively to any challenge issued about the effectiveness of a particular transaction.

Prior to the introduction of negotiated brokerage rates on 1 May 1975, many firms predicted and were confident, that the charges they would impose for the various services they offered, could be sustained. I understand that one of the most widely discussed schedules was the "Goldman

Sachs" guidelines. These established rates about 8% below those which applied prior to May. Initially, it seemed that these rates could be held. However, soon afterwards, the signs of disruptive price competition began to become evident. Some of the more aggressive brokers reminded traders of their responsibility for "best execution" as they offered to complete transactions at rates which were 40-50% of the old rates. I believe that the New York Stock Exchange estimated that the total reduction in brokerage charges in May 1975 was $25M. All firms were affected, and the research houses, as they were forced to meet the market, desperately sought ways in which they could cut their overheads. Clearly, those who had been relatively complacent about the advent of negotiated brokerage, were quickly stimulated, once it became fact.

There were other consequences of the change. If a broker was unsuccessful when he attempted to persuade a client to buy or sell stock, it was now possible that his proposal was declined merely because of the rate at which he was prepared to complete the transaction. He then had to decide whether to offer again at lower rates, without knowing if the institutional buyer were genuinely interested. When he did so, he made it clear that he was willing to cut his rate further. Hence he was effectively establishing a new rate at which he was prepared to complete business, as it would be very difficult to revert to the higher rate.

After the new arrangements applied, institutions were less willing than they had been previously, to place orders or, in other words, initiate business. They were correspondingly more willing to respond to offers. However, the brokers were equally anxious to seek orders, as these gave them stock to offer and an established trading position. Old relationships tended to founder, as the initiation business was placed with those firms willing to offer rock bottom rates. Brokers soon responded by opening a wider gap between rates charged for initiation business and response business.

There have been other consequences of the change in the basis of charges. Firms primarily dependent upon institutional business were most severely affected. There has been a great deal of effort expended to widen the range of clients, because the small business is, effectively, becoming the most profitable.

Quite clearly, many firms were obliged to cut rates to levels which were uneconomic, simply to attempt to survive. Necessarily, some failed to do so. Proponents of negotiated brokerage contend that this is the price paid for inefficiency. Others, not so enthusiastic about negotiated brokerage, suggest that this is one of the opportunities such a system offers to strong firms. It enables them to drive weaker firms out of business and limits their competition. I also add that being "strong" does not necessarily equate with being efficient. It simply means an ability to operate uneconomically for longer than some of your competitors. Irrespective of the merits of these conflicting views, the situation imposed a further problem upon many fund managers. They knew that some broking houses were becoming strained and they needed to satisfy themselves continually that they were not entering into transactions today with a broker who may be declared insolvent tomorrow.

I have taken some time to trace the events that gave rise to the introduction of negotiated brokerage in the United States. I have also offered some comments about changes in trading patterns and investment management practices which took place after negotiated brokerage was introduced. It may be that our experience would differ from that which arose in the United States, if we were to follow their example. However, as far as I am aware, it is the only major Exchange to have adopted the system and therefore offers the best, and indeed the only, background upon which to make judgements about such a system.

I drew attention previously to the legal, statutory and competitive pressures which culminated in the adoption of a negotiated brokerage system in the United States from 1 May 1975. Our local Trade Practices Act appears to be the only parallel legislation likely to result in the Exchanges being forced to introduce the system in Australia. At the same time, I think it wrong to place too much emphasis upon the legal pressures which arose in the U.S.A. It impresses me that NASDAQ could only have been introduced as a response to dissatisfaction with costs incurred for services offered by Exchange members. The fact that even the President of the Exchange was publicly critical of some Exchange practices as early as November 1970, implies that there were grounds for believing that the Exchange had allowed its own standard of management to deteriorate. Ultimately, any Exchange essentially provides a service to the public through its members at a cost. Like any other business, it will be confronted with competition, legal suit or the threat of control by legislation, if it fails to provide adequate service for the price charged for that service.

I believe that the group which has the primary duty to satisfy themselves and the public on these points, are the Exchanges and their members. It is my experience that most broking houses take considerable care with proper registration of documents, collection of entitlements to dividends, bonus issues, etc. Perhaps, the greatest difficulty in assessing the equity of present arrangements, flows from the "bundling" of services. All of us are aware that some firms spend a great deal of money and effort on research, while others do very little. Some firms act as underwriters for equity and fixed interest issues, for which they charge separate fees. However, it is difficult to establish whether those fees are more or less than adequate to cover the costs involved. It is my personal opinion, that most people accept that charges can never be set in a manner which offers complete equity to every client in each transaction. However, overall the client will look for other ways of completing his business if he considers he is not being treated fairly as to price and service.

I do not think it possible to over-emphasise the fact that negotiated brokerage is only one alternative to the present scale of charges. There are really many other options available, if it is believed that present arrangements are unsatisfactory. For example, brokers could be allowed to negotiate brokerage rates only if the transaction involved consideration in excess of, say $200,000. There could be a much lower charge made in terms of rate if consideration exceeded a certain amount. Again brokers who provide research material, could be permitted to charge for that material separately. All of these suggestions are open to some obvious criticisms. Nevertheless, I think it would be unfortunate if we began to believe that the only alternative to existing arrangements, is negotiated brokerage. It may well be the best alternative, but I think that has yet to be established.

In this paper, and I know it happens in many other areas of business, major attention has been given to the large buyers and sellers in the market place. It is important that consideration also be given to the small client. If the result of a system, other than that now operating, were the imposition of higher costs upon the individual investor, then I think that would be regrettable. He has a role in the market place, and the greater the number of people who become involved in the market, and who find it works efficiently, then the greater the prospect we all have of continuing our system of free enterprise. If members of the Exchange use the yardstick of efficiency for measurement of company performance, it is both appropriate and consistent that they apply the same principles to their own operations. If they do so, it is likely that present commission arrangements will continue unchallenged, although not necessarily at existing levels. Should the Exchanges meet with competition from a form of second market, then they will be well equipped to meet it if they are genuinely satisfied that they offer efficient service at a reasonable price. If they fail to apply these principles to their main operations, it is inevitable that present arrangements will be challenged. It then becomes likely that, as evidenced in the United States, the challenge is successful.

VISIT BY NEW YORK SOCIETY OF SECURITY ANALYSTS

The Securities Institute of Australia is arranging the itinerary within Australia for a group from the New York Society of Security Analysts, who will be in this country from Sunday, October 30, to Saturday, November 12, 1977.

The group will arrive in Sydney, spend two working days there for briefings and company meetings, visit Canberra on November 2 and then move on to Melbourne for further company meetings. On Sunday, November 6, the group will fly to Mackay. It is planned that they will visit the Utah coal areas on the following day and then fly on to Mt. Isa. After visiting M.I.M. Ltd., the route to be taken is via Darwin to the Pilbara to inspect the operations of Hamersley, Mt. Newman and Robe River. On Friday, November 11, Alcoa's operations at Pinjarra will be visited, thence returning via Kwinana where it is planned to inspect Western Mining Corporation's nickel refinery. The party will fly out of Sydney for the U.S.A. on Saturday evening, November 13.

Overall control of the itinerary is being handled by Federal Council, but detailed planning within States will be the responsibility of the respective Divisions.

It is hoped that functions can be arranged in Sydney, Melbourne and Perth at which our members will have an opportunity of meeting members of the visiting group.

After bookings are finalised in New York, vacancies, if any, to make up group numbers to 40, will be available to S.I.A. members at cost for the final week (ex Melbourne, Sydney or Brisbane), i.e. from Sunday, November 6 to Saturday, November 12, covering the tour of mining areas. Any member interested in joining the party should contact their Divisional Secretary for further information.