THE BRAVE NEW WORLD FOR BANKS, MERCHANT BANKS, STOCKBROKERS

Paper Presented by

James K. Bain

Chairman, The Sydney Stock Exchange Limited

This paper was presented at a lunchtime seminar held by The Securities Institute of Australia, New South Wales Division, May 10, 1984. The other speakers were Mr. Ian Matheson, Deputy Managing Director, Westpac Banking Corporation and Mr. Christopher Corrigan, Managing Director, BT Australia Limited.

For the past two and half years the proposed deregulation of the stockbroking industry in Australia has caught the imagination of the nation's financial press. No other subject except perhaps the possible entry of foreign banks has stimulated so many articles by financial journalists. Now that the deregulation is gathering momentum it will be interesting to see how the press reacts to the further developments over the next few years.

On April 2, 1984 the Australian stockbroking industry took the second of three major steps towards deregulation, with the introduction of totally unfixed brokerage rates. Last week the Ministerial Council approved the amendments to the Articles of Association of the six capital city stock exchanges, thus completing the third step in the deregulation process. This third step allows broking houses —

1. to incorporate,
2. to issue up to 50 per cent of their voting shares to non-members of the stock exchanges,
3. to issue any amount of non-voting shares to non-members of the stock exchanges,
4. to appoint non-members of the stock exchanges as directors of member corporations so long as the number of non-member directors does not exceed the number of member directors, and
5. to become member organisations of more than one stock exchange.

These changes are the most dramatic in the deregulation process but the process actually began in September 1982 when the restrictions on advertising were removed and member firms were allowed, for the first time, to approach non-clients to solicit business.

The deregulation of the securities industry in Australia is part of a world wide trend which began in the United States away back in the 1950's as a consequence of the liberalisation of business and legal attitudes in that country towards fiduciaries investing the funds under their management in equity securities.

The deregulation of financial markets in the US has had, and will continue to have, a ripple effect on the financial systems of all the other countries in the free world. The effects of the ripple are —

a. once started the policy of deregulation cannot be halted,
b. the financial systems of other capitalist countries will inevitably be affected by the US experience,
c. the greater the inter-dependence existing between the financial systems of a country with that of the US, the stronger will be the pressures for deregulation,
d. the most aggressive supporters for the deregulation of financial systems outside of the United States are US financial intermediaries which have survived to enjoy the benefits of deregulation in their own country and wish to take advantage of their experience to cull for themselves the most lucrative business available in those other countries, and
e. the movement towards the internationalisation of financial markets will accelerate.

Canada was the first country to feel the effects of the ripple.

However, Canada's move towards the deregulation of its securities industry was somewhat less traumatic than it has been in Australia because in Canada there is no separation between merchant banking and stockbroking. The Canadians recognised, much earlier than Australians did, that merchant banking could not grow within the stockbroking industry as quickly as its development warranted, unless stockbrokers were allowed to incorporate and thereby expand their capital base.

The first Australian merchant banks were offshoots of stockbroking firms but the exchange members' myopic stand against incorporation forced these firms to dispose of them. Perhaps there is then poetic justice in the fact that it was the merchant banks which forced the abolition of fixed brokerage rates.

In Australia, the unfixing of brokerage rates and the admittance of financial institutions into the stockbroking industry has been inevitable since the enactment of the Trade Practices Act in 1974. The underlying principle of this Act is that price fixing is contrary to public policy unless the price fixing is initiated and controlled by Government. The Act outlaws price fixing in respect to goods. The Swanson Committee which reported to the Fraser Government in August 1976 recommended that price fixing in respect of services also be made illegal, per se.

The Government did not accept the Swanson Committee's recommendation but the wording of the Trade Practices Act makes it most unlikely that the Trade Practices Commission (TPC) will ever authorise an agreement which is aimed at fixing prices in a market for services. The Australian Associated Stock Exchanges recognised this fact as early as 1974, but it was instructed by the Committees of the six capital city stock exchanges which it represents, to defend the status quo as long as possible. To achieve this end the AASE successfully employed numerous delaying tactics over a period of seven years.

Finally, in June 1981 the Committee of the Australian Merchant Bankers Association brought the matter to a head by issuing a Writ Mandamus against the TPC which would have required it to proceed to determine the stock exchanges' applications for authorisation of their practices which may lessen competition, without further delay. The TPC avoided judgement on the writ by giving an undertaking to the court that it would carry out its duty under the law, and proceed immediately to consideration of the exchanges' applications.

The motives behind this drastic move by the Merchant Bankers appear to me to have been —

1. there was a strong feeling among those Merchant Bankers who were also large fund managers such as BT, AUC and Schroder Darling, that brokerage rates were too high on the medium to larger transactions. The stock exchanges had reduced rates on orders over $500,000 from 1.0 per cent to 0.5 per cent but could not agree among themselves on further reductions,
2. there was great concern that the Part C "on market" takeovers which have to be conducted on the trading floors of the stock exchanges were earning the brokers very high fees at the existing fixed rates with no rebate or other form of compensation to the merchant bankers which had, in many cases, initiated the takeover, and
3. with the trend towards freeing up the banking system the merchant bankers were having the margins on their banking/lending operations reduced and they saw the possibility of buying into stockbrokers as another source of income which would in part compensate for the loss of this revenue.

The TPC enquiry commenced in July 1981 and the final determination was handed down in September 1982. The principal changes were —

Firstly, stockbrokers were permitted, from the date of the determination to approach the public and advertise freely. Previously unsolicited communications to "non-clients" had been prohibited by the business rules of the stock exchanges and although advertising had been permitted in recent years, it was strictly policed by the Exchange Committees.

During the past decade, savings institutions such as Building Societies, Savings Banks, Finance Companies, Credit Unions etc., have all become more aggressive in their campaigns to attract funds from individual investors.

From some figures produced by Bain & Company last year, we estimate that at June 30, 1983 there was approximately $55 billion of private savings held in those institutions, of which only about 10 per cent ($5.5 billion) had benefited from any form of independent financial advice, principally from stockbrokers and investment advisers.

It is expected that a significant portion of those savings can be attracted to the stockmarket because stockbrokers can now take the initiative and approach a much wider group of potential investors, and because the major trading banks with their extensive branch networks, massive capital resources and data processing capacity are entering the industry. Thus it can be expected that the stockmarket will grow in size and liquidity.

I also believe that in the more competitive atmosphere, stockbrokers will be increasing their range of financial services to attract a larger proportion of the private savings previously mentioned. We have a big job ahead of us in educating the new investors, but the introduction and dramatic growth of the cash management funds in the past three years, is a first step in the education process for those who in the past have placed funds only with buildings societies and savings banks.

The second important aspect of the TPC determination was to remove fixed brokerage rates.

The original proposal authorised by the TPC was for fixed rates to remain at their existing levels for transactions up to $100,000 for eighteen months from April 2, 1984 to October 1, 1985, with negotiated rates to apply to that part of all orders over $100,000.

This proposal would have created some serious administrative difficulties and fixed rates at the bottom end were going to be very difficult to uphold in the deregulated climate after April 2, 1984. In addition, the London brokers decided earlier this year to introduce fully negotiated rates for transactions in foreign stocks (including Australian stocks) from April 9, 1984. You will be aware that apart from competition in the international markets there are several London brokers with branch offices in Australia dealing directly with the Australian institutions in Australian shares so it was decided to go for "the big bang" and adopt unfixed rates for all transactions from April 2, 1984 — ten years after the Trade Practices Act became law!!

It is my personal view, a view which has so far been borne out by events, that the majority of brokers will initially charge much the same brokerage rates to *private clients* as under the fixed rates regime, except where special research or advisory services are required, when a higher rate or higher minimum charge will be justified. If a client is not satisfied with a particular broker's charges there will be plenty of other brokers competing for his business, including several discount houses which will provide "no frills" executions at minimum cost.

The brokerage on institutional transactions will be reduced, although the extent of the reduction is not yet known. It appears that most institutions would like to operate for a flat rate of, say, 0.5 per cent to 1 per cent depending on the circumstances. This rate will include the cost of other services provided by the member organisation, principally research. However, some broking houses are already charging less than 0.5 per cent, presumably in an attempt to gain market share. It is not for me to comment on my competitors' strategy, but I will remind this audience that that tactic proved unsuccessful in New York in 1976.

The third important result of the TPC determination is to permit stockbrokers to incorporate with limited liability and bring in outside shareholders. Prior to April 2, 1984 stockbrokers could only operate partnerships of natural persons with unlimited liability.

In a package deal negotiated with the major market users, being representatives of the Australian Bankers Association (ABA), the Life Insurance Federation of Australia (LIFA), and the Australian Merchant Bankers Association (AMBA) last December, it was agreed that the AASE would withdraw its objections to the Banks and Life Companies entering the industry, provided they agreed to buy through existing broking firms or existing members. On this basis outside shareholdings of voting shares would be limited to a maximum of 50 per cent for the three years from April 2, 1984. The package was granted interim authorisation by the TPC. The Ministerial Council for Companies and Securities has not disallowed this package. Rules have now been agreed between the AASE and NCSC to deal with the new potentials for conflicts of interest which these arrangements could otherwise give rise to.

It has already been announced that Elders IXL will buy 40 per cent of Roach Ward Tilley & Co. and the National Australia Bank will buy 50 per cent of A.C. Goode & Company. In addition, Westpac has announced it is negotiating with a broker. Bain & Company at this stage has decided to remain an independent partnership.

The stock exchanges decided to adopt whatever policy in relation to foreign ownership of stockbrokers was decided by the Foreign Investment Review Board in terms of the Federal Government's General Policy on foreign ownership in the financial system. It was expected that the upper limit of 50 per cent would be approved for foreign residents, but the Federal Treasurer, The Hon. Paul Keating, announced on April 18 that the Government had decided to restrict foreign ownership in a stockbroking corporation's equity to 40 per cent in aggregate and to 15 per cent in the hands of any one non-resident. The Treasurer said that this policy would be reviewed in the light of subsequent developments. I hope that this policy does not result in an over concentration of the stockbroking industry among the broking firms that could be 50 per cent owned by the major trading banks. I can assure you that the remainder of the industry will not be backward in bringing any over concentration to the Treasurer's attention!

This restrictive attitude to foreign ownership of stockbrokers is a setback to full deregulation. It is estimated that 23 of the 25 merchant banks which are members of AMBA, are foreign owned and controlled. It is my view that many of the new innovations and initiatives would have come from major overseas brokers and merchant banks who, in my opinion, will not be prepared to make the necessary commitments of skilled staff, expertise and technology if they can only own 15 per cent of a member corporation.

In the Bain & Company submission to the TPC last year, we indicated that apart from increased permanent capital, the real advantage from incorporation was the "value added" which could be provided by a 50 per cent shareholder. Under current regulations these advantages will be confined to local banks and institutions which in most cases, do not have direct experience in international security markets.

You will have read in the press that AASE and the NCSC has had some difficulty in agreeing new stock exchange business rules to regulate the new potentials for conflict of interest which could arise following the participation of other financial intermediaries in the ownership of stockbroking corporations.

Sections 66 and 131 of the Securities Industry Codes give legislative backing to policies which have been included in the exchanges' business rules for many years. Section 66 requires a dealer, (the term "dealer" includes a stockbroker) when dealing for himself or on behalf of a person associated with him, to declare to the client with whom he is dealing that he is dealing as principal. Section 131 requires a dealer to subordinate his own order, or an order from a person associated with him to an unfulfilled order on the same terms for the same security, from any other client. The stock exchange's rules apply these policies of declaration as principal and subordination of orders, to transactions by, or on behalf of, the broker, the member firm, the broker's family, family companies and family trusts in addition to persons associated with the broker as defined in Section 6 of the Securities Industry Code. I am sure that I need not tell this audience how wide and ambiguous is the definition of "a person associated with a person" in Section 6.

The crux of the difficulty facing the AASE and NCSC was — how should these business rules be amended in relation to orders received by a member corporation from its own major shareholder? The difficulty was further complicated by two other issues.

First, many potential major shareholders are themselves financial intermediaries which manage funds for others and act for their own third party clients.

Secondly, in a deregulated environment it is expected that several broking houses will promote and manage directly or indirectly, their own investment trusts.

The stock exchanges wanted to amend the rules in a way that would not discourage other financial intermediaries from acquiring a major interest in a member corporation. The NCSC took a much more legalistic view and seemed to be aiming for rules which would follow the well known and conservative dictum — that an agent cannot serve two masters. Clearly, the ripple effect of which I spoke earlier has, as far as the financial system is concerned, long since set aside this conservative dictum — otherwise the one stop finance house could never have developed either in the United States or in the United Kingdom.

The stock exchanges suggested that recognition of Chinese Walls procedures could overcome the difficulties, since these procedures had been adopted for many years by banks, merchant banks and stockbrokers as a means of dealing with insider information problems.

The NCSC rejected this suggestion in relation to "declaration when dealing as principal" and "priority of client order" rules. It took the view that declarations of trading as principal and the need to give orders from arms length clients priority over other orders, had little to do directly with insider information or insider trading.

After much study of, and discussion on, these problems it was eventually agreed that when a member corporation enters into a transaction on behalf of its substantial shareholders and their related companies, with another client, it should declare to that client that it is dealing as a principal. It was also agreed that a member corporation will subordinate orders from its substantial shareholders and their related companies for their own account; to unfulfilled orders on the same terms for the same securities from other clients. This rule of subordination WILL NOT apply to orders from substantial shareholders of a member corporation when those orders are on behalf of —

1. funds managed by the substantial shareholder,
2. the substantial shareholders own clients, or

3. a life insurance company which is a substantial shareholder and is acting on behalf of its statutory funds.

The press may have given the impression that the NCSC totally rejected the concept of Chinese Walls being included in the stock exchange business rules. This is not so. In rule 3.14 — Prohibition of Advice to Clients — there is for, the first time in Australia a specific definition of the term "Chinese Walls". The rule provides that where —

> "as a result of a relationship with a client, a Member Organisation is in possession of information that is not generally available in relation to a Security and which would be likely to materially affect the price of that Security if the information was generally available, the Member Organisation shall not give any advice to any other client of a nature that would damage the interest of either of those clients."

For the purpose of this rule —

> "A Member Organisation shall not be regarded as having possession of information that is not generally available in relation to a Security where the Member Organisation has Chinese Walls in place and the person advising the client is not in possession of that information."

Incidentally, in this rule — the word "client" includes a shareholder in a Member Organisation.

The stock exchanges expect that as the NCSC gains experience of the operations of Chinese Walls it will agree to extend their operation to other of the business rules.

The exchanges have also introduced three new business rules in relation to Discretionary Accounts, in summary these are —

1. before a Member Organisation operates a discretionary account for a client it must first obtain written authorisation from the client. This authorisation shall set out the terms and conditions under which the account will operate and shall include a reference to the rates of brokerage which the client will be charged. A Member Organisation cannot buy or sell shares in itself on behalf of a discretionary account,
2. a Member Organisation faces expulsion from the exchange if, in the opinion of the Committee, it has engaged in what it is commonly known as "churning" in relation to the operation of managed funds or discretionary accounts, and
3. a client on whose behalf a Member Organisation operates or manages a discretionary account or other funds, may require the Organisation to prepare a report on a quarterly basis setting out —
   a. the value of the transactions in securities executed on behalf of the client,
   b. the amount of fees and brokerage charged to the account, and
   c. the value of transactions executed during the quarter, expressed as a percentage of the market value of the account at the quarter date.

Another new rule will require a Member Organisation to advise a client, which seeks the information, of the policy it adopts in the allocation of the securities it buys and sells to fulfill orders placed with it.

The capital adequacy rules have been amended to require a Member Organisation of the Melbourne or Sydney exchanges which is a corporation, to maintain adjusted liquid capital of $250,000 or 5 per cent of aggregate indebtedness, whichever is the greater. $100,000 will be the minimum amount required to be maintained by corporate Member Organisations of the Adelaide, Brisbane and Perth exchanges.

I hope that these agreed rules will prove to be satisfactory in practice. They will be kept under review and further amendments will be put forward by the exchanges, if necessary. For the sake of the record I should mention that although these new rules have been agreed to by the stock exchanges and the NCSC all of them are subject to the Ministerial Council's disallowance procedures and some of them will require authorisation by the TPC before they can be formally adopted or enforced.

There is also the matter of the crossing rule which sets out the procedure for "marrying" shares when a broker is acting for the buying and the selling client or clients.

As you are probably aware, the existing crossing rule requires that *all stock* goes through the market when the orders to be crossed are under $500,000 and all crossings above this figure are treated as specials without the requirements to "show" them to the market. I am concerned now that the Australian exchanges are the only exchanges entering the era of deregulation without a specialist or jobbing system.

It seems inevitable that a number of broking firms and other financial institutions will fill this vacuum and will become more active as principal dealers in the equity market.

The main reason for concern is that the market in equity securities may tend towards the market for Commonwealth Bonds in Australia, where transactions are being conducted in minimum parcels of $1 million on the Reuters screen by a group of the larger broking firms, merchant banks and other financial institutions. The public has no access to this market, except through the complex tender system or when one of the large dealers sells some small parcels out of its holdings as principal to private investors, usually by newspaper advertisement.

The public does of course have access to Commonwealth Government Securities through subscription to Australian Savings Bonds, however, it is my view that if the equity market were to develop in the same way, the public would be excluded from participating in any of the larger trades and the market would become fragmented. I believe this outcome would be unacceptable from a political point of view and would be totally unacceptable to the authorities on public interest grounds.

In an endeavour to overcome this problem, the Sydney Exchange attempted to devise a more flexible crossing rule which —

a. encourages the institutions to put the stock through the market without losing control of the majority of the parcel,
b. protects the public so that it can participate in a reasonable proportion of the stock available at the crossing price, and
c. causes a proportion of the special deals above $500,000 to be exposed to the public market.

The NCSC has indicated that it will not approve any change to the crossing rule unless the exchanges can provide evidence that the move will result in more stock going through the market for the public benefit.

On this basis, the Sydney Exchange is monitoring the number of crossings and specials and negotiations are continuing with the major institutions who are users of the market in an endeavour to find a solution to this complex problem.

In conclusion, if I may be permitted the benefit of hindsight, I think it would have been better for the securities industry if the stock exchanges had voluntarily and gradually deregulated their business rules and procedures over the past five years.

Unfortunately, it was impossible to obtain the agreement of the Committees of the six stock exchanges to any major changes and the status quo remained until the TPC's determination. In any case gradual deregulation is difficult, if not impossible, to accommodate within the provisions of the Trade Practices Act. The industry was then faced with the major changes I have outlined — all occurring within eighteen months. This is obviously very unsettling for the majority of stockbrokers who have operated in an industry which has had fixed rates and limited competition for more than 100 years.

I believe, however, that the deregulation moves will result in a significant growth in share markets in Australia with a widening of the financial services available to the public and a greater participation by individual investors.

The development of a substantial and expanding equity market in Australia will facilitate the raising of the huge amounts of equity capital required for our future development and maximise the proportion of equity held in Australian residents' hands.

Because Australia has only 15 million people, with relatively low public participation in the stockmarket and a limited number of institutional participants, it is essential that the market grow in size and liquidity and in my view this can be facilitated if the transactions are channelled through the trading floor with full disclosure of price/volumes, and the opportunity for all partipants to share in the bargains.

There is strong support among many of the institutions for disclosing the price and volumes of off-market transactions and with the co-operation of those immediately concerned it should be possible to resolve these remaining matters within the next year or so.

I believe that we are about to embark on an exciting new era in the stockbroking industry and I am confident that those who can offer their clients an adequate and innovative service will prosper — thank you.