THE GROWING INTERNATIONALISATION OF SECURITIES MARKETS — IMPLICATIONS FOR AUSTRALIA

An Address by

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I welcome this opportunity of saying something about the growing internationalisation of securities markets and in particular, developments which have taken place in the principal world securities markets such as New York, London, Tokyo and Toronto and then to indicate how Australia may be affected by some very fundamental structural changes that are taking place in the world's securities markets. The introduction of the new Securities Industry Code in 1981 made it possible for the first time in Australia for a national commission to have oversight over Australian securities markets. The Formal Agreement — the political compact between the Commonwealth and each of the States — provided the Commission with a legal frame of reference upon which regulation, principally based upon disclosure of relevant financial and other information, could be advanced as a coherent policy objective in order to achieve two of the stated aims of the Formal Agreement, namely, greater efficiency of Australia's capital markets and maintenance of public confidence in organised securities markets in Australia by the introduction of suitable provisions for investor protection.

Structural Change in Australia

Since the establishment of the National Companies and Securities Commission in 1980, significant changes have taken place in the structure of not only the securities industry, but also of the securities markets. In particular, competition has re-emerged not only as an ex post facto rationalisation for economic growth, but also as a self-evident justification for social and economic behaviour.

The present Commonwealth Government has stated many times that competition in the market place should be the prevailing factor and that commerce and industry should be less dependent upon cartelised structures.

A number of important changes in Australia's capital markets have taken place during the past year. In particular, there was the announcement by the Commonwealth Government in December 1983 to relax the exchange controls which had remained substantially unaltered since World War II and to free the exchange rate. Other structural changes had been occurring in relation to the securities industry. The development of the new technique — "the on-market offer" not only pointed to the ability to acquire control by on-market acquisitions during the course of the takeover. It also became the catalyst for a sometimes acrimonious debate concerning the degree of cartelisation inherent in the regime of fixed commissions.

It was not surprising, therefore, that the stock exchanges found it increasingly difficult to resist the demands, particularly by the Australian Merchant Bankers Association, for termination of the regime of fixed commissions. The regime of fixed commissions came to an end in Australia on 2 April 1984, as a result of the determination made by the Trade Practices Commission. This will have important implications for the industry, as market intermediaries seek to supplement diminished revenue.

It is useful at this point to make mention of other important changes. Household investors in the last decade have tended to look for markets other than the traditional equities markets for various reasons — on the other hand the portfolios of institutional investors in quoted stocks have expanded rapidly. Also the strategies of portfolio managers have tended to be more directed to the short term rather than "long haul". The reasons for these changes are complex and time does not permit amplification of these matters.

Other issues have also come to the forefront. In Australia, we have seen a blurring of the role of financial institutions such as banks, life assurance companies and merchant banks and these financial institutions have continued to expand into areas which have hitherto been the traditional and conventional preserve of other institutions.

The issue of entry to the exchanges fell to be determined by the Trade Practices Commission, and the resulting determination late last year has had the effect of liberalising entry to the Exchange by allowing resident financial intermediaries, subject to certain conditions, to take up to 50 per cent interest in Australian stockbroking firms.

New Technology

Concurrently with the new deregulatory environment, new computer/communications technology also brought further change.

The new technology has made it possible for material information to be relayed contemporaneously to all market participants. Beginning with the capture, process and dissemination of trading data, it is possible for the electronic system to be expanded to encompass execution of trading in securities on a 24 hour basis through strategically placed terminals to which direct access is possible. The immediate capture of trading data will not only generate market reports, it will facilitate inter-broker claims and bring about a transfer of ownership. It ultimately may eliminate the need to transact business on a trading floor which has been the traditional feature of a stock exchange.

In this connection it is relevant to mention NASDAQ, the National Association of Securities Dealers Automated Quotation System which is now being espoused as the prototype trading system. NASDAQ is not a stock exchange; it is an electronic dealer system utilising the latest developments in technology. Continued improvements in computer technology have not only resulted in a fully integrated trading system, but the introduction of computer-to-computer interface has also resulted in the production of vital information such as real time execution and volume trading. It is also to be noted that in July of this year, the London Stock Exchange announced that after examination and investigation of a number of trading systems, it had opted for NASDAQ instead of Wall Street's big board auction system, because it was felt that NASDAQ had potential for development as technology advanced and was better suited to the realities of a global 24 hour market in securities.

Mr. J.K. Bain, the Chairman of the AASE, in an address to the Australian Society of Corporate Treasurers, has foreshadowed that the AASE is likely to follow the NASDAQ model. The Commission welcomes the general thrust of these initiatives by the stock exchanges.

The development of computer technology overseas has not been restricted to private agencies. As recently as 24 September of this year, the SEC inaugurated a computer filing system designed to provide immediate access to that agency's public reference files.

The filing system means that the SEC will begin to make available instantaneously to investors and analysts using computers millions of pages of company disclosures. In the first stage of the programme the data will have restricted access at the SEC's public reference room in Washington, New York and Chicago, but the ultimate plan involves providing access to information to investors utilising home computers.

About 150 companies have volunteered to become part of the pilot programme with about 1,000 expected to be participating by next March.

In its fully developed stage, electronic filings by corporations will become available to the public almost instantaneously. An investor sitting at a home computer will be able to check daily or more frequently vital information including prospectuses, quarterly and annual reports, tender offers, proxy statements and registration forms for public offerings of securities.

Contemporary history is a fickle mistress. Assessments in terms of contemporary history are always at best tentative and lack real knowledge. There is the even graver matter of proportion. It is impossible to estimate accurately the significance of various events in a relatively short period. Some events can be seen to be portentous from the very moment of their occurrence, others of equal moment are in obscurity. There are however, some obvious trends, not withstanding they cannot be assessed with the full rigour of historical analysis.

Overseas Developments

Turning to New York, the bull market collapsed at the end of 1969 with some significant consequences for many brokerage houses. In the boom years, the trading volume meant that the brokerage houses were inundated by a flood of paper-work and many beleagured members of the New York Stock Exchange found it necessary to merge. It is neither useful nor practical to detail these mergers but merely to take one example, Shearson Lehman-American Express is the product of many mergers which have been consummated over a period of some 20 years. It incorporates such well-known Wall Street names as Hayden Stone and Co., Shearson Hammill, Loeb Rhoades and Co. and Hornblower and Weeks, resulting in the disappearance of many historical names when in 1981 Shearson Loeb Rhoades was merged into American Express, under its previous name of Shearson, American Express. The present firm of Shearson Lehman-American Express represents a merger of Shearson American Express and Lehman Bros., Kuhn, Loeb & Co., which is itself a product of two famous old line firms of Lehman Bros. and Kuhn Loeb & Co.

This shakeout among brokerage houses was accelerated following the termination of the regime of fixed commissions which finally took effect on 1 May 1975 after 7 years of protracted debate. Old line houses which had been content to underwrite stocks and bonds and to sell to institutional investors have found it necessary to expand into full service firms incorporating retail operations, market making, block trading as well as underwriting, all of which required both size and capital.

The industry in the United States continues to be affected by the Glass Steagall Act, a measure which was adopted in 1933 and which had the effect of separating functions between commercial and investment banking. In particular, commercial banks since 1933 have been required to choose between deposit and investment banking and have been restricted from carrying on underwriting activities except certain exempted underwritings, such as general obligation bonds of federal, state and municipal bonds, and bonds of government corporations.

The sharp rise in interest rates in the early 1970's also had the effect of upsetting what had been for decades a comfortable balance of power. Banks and savings institutions were precluded by regulation from paying market rates for interest to short term depositors, but security firms could establish cash management funds which in effect had the effect of diverting substantial deposits from the banks. This led the banks to involve themselves in diversification programmes and the functional barriers between securities firms, banks and insurance companies became increasingly blurred. Currently there is great pressure upon Congress by banks to repeal the Glass Steagall Act.

The last few years have seen the emergence of securities firms which offer a full line of products. For example, Merrill Lynch offers facilities such as interest on deposits, cheque facilities, loans, mortgages, credit cards, market funds of all descriptions, securities dealings, life assurance, mortgage insurance, buying and rental of real estate and cash management accounts — a far cry from the traditional securities firm of scarcely more than a decade ago.

Developments in New York have in turn placed enormous pressure upon London and its future as an international city.

As is well known, London securities markets have been distinguished by the demarcation between jobbers and brokers — "single capacity", meaning that by tradition and by rules of the London Stock Exchange, members are forbidden to transact agency business if they are engaged in market making.

As a result of the single capacity requirement, London brokers and jobbers have been up-to-date, comparatively small organisations lacking the resources of the large international firms with branches or subsidiaries in London, such as Merrill Lynch, Salomon Brothers, Goldman Sachs, Nomura Securities and other international firms.

U.K. merchant banks (some of which are owned by English clearing banks) were limited in their ability to participate in domestic securities markets by the single capacity rule and because of the inability to gain admission to membership of the London Stock Exchange under the existing rules. A matter of concern has been that a significant portion of transactions in securities of well-known U.K. corporations have been diverted to foreign markets, particularly to New York firms; in contrast non-resident securities organisations have achieved predominance in the international securities markets based in London, particularly in the Eurodollar markets.

The London Stock Exchange, under some Government pressure, agreed in 1983 that the minimum commission structure on the stock exchange which affected trading in equity securities and gilts would be abolished by the end of 1986. Also, the rules of the Exchange have been altered to permit persons other than members to take up to 30 per cent interest in stockbroking firms, and U.K. trading banks, merchant banks and other organisations have positioned themselves by acquiring interests in stockbrokers and jobbers in the expectation that with the termination of the regime of minimum commissions, the single capacity rule and the restriction on ownership by non-members will also be removed.

By December 1986 it is anticipated that the London Stock Exchange will not only have liberalised the rules of entry to the stock exchange — a process which is taking place now — but also the traditional regime of minimum commissions will have been terminated. Since 9 May of this year, members of the London Stock Exchange have been able to deal in stocks of overseas recognised stock exchanges at less than the full commission laid down in the Rule book. This means of course that members of the London Stock Exchange can deal in Australian domestic stocks on a negotiated commission basis. In fact, the ablity of members of the London Stock Exchange to do so was one of the principal reasons why the Australian Stock Exchanges agreed to amend their own rules to permit transactions on negotiated commissions without the need for the intermediate threshold figure of $100,000 referred to in the determination made by the Trade Practices Commission in September 1982.

With the termination of fixed commission rates in the U.S., increasingly shares in U.K. domestic companies stocks such as BP, Shell, ICI, BAT, Glaxo, Beecham, Plessey and Thorn-EMI, have been dealt in on an international basis and in particular, in New York and European stock exchanges.

In the May edition of "Euromoney", there appeared a ranking of what was described as "genuine international equities". There were 236 of them, that is to say, corporations whose stocks have become so internationally acceptable that there is an active liquid market for them in at least one overseas exchange. Of the 236 stocks on the list, 84 are American, 49 are Japanese, 17 are German, 16 are Australian, 13 British, 12 Canadian, 10 Swedish, 7 Dutch, 7 South African, 5 Swiss and 4 from Hong Kong. Stocks from Italy, Belgium, New Zealand, France, Denmark, Norway, Singapore and Malaysia account for the rest.

For those who are interested the Australian stocks listed in Euromoney are BHP, CRA, MIM, Westpac, Western Mining, CSR, ANZ, Santos, National Australia Banking Group, Bougainville, Elders IXL, News Corporation, North Broken Hill, Woodside, Thomas Nationwide Transport and Peko Wallsend.

Challenge to Australia's Securities Industry

Whereas the Australian securities industry has typically dealt in Australian domestic stocks on the trading floor of an Australian stock exchange, a growing pattern of change, so far as Australia's largest corporations are concerned, is now emerging. This is not to say that Australian securities markets will become wholly international, but with the lifting of exchange controls, large Australian corporations will seek to buy assets outside Australia and will undoubtedly raise equity capital in those markets where it is cheapest and most readily available in size. This of course will be subject to those constraints implicit in FIRB and Treasury policies concerning non-resident ownership.

When an investor, whether he be an Australian or foreign, spreads his portfolio across a national frontier he seeks to spread his risk. He will seek out the markets which provide the greatest depth and liquidity. In the case of large companies, the most liquid of the available markets are firstly in New York and secondly in London. Certainly these developments present a challenge to the traditional Australian domestic market place, the traditional Australian trading floor and the traditional Australian brokerage houses who engage almost exclusively in agency transactions. Some Australian firms have sought international connections. Cortis & Carr has linked with Prudential Bache Securities Inc., one of the largest of the New York brokerage houses; Wardleys Ltd. (a subsidiary of The Hongkong and Shanghai Banking Corporation) has linked with Rivkin Limited; Hoare & Govett (a U.K. stockbroker) has linked with McIntosh Griffin Hamson and Morgan Grenfell Ltd. (U.K. merchant bankers) with Hordern Utz & Bode. Not all Australian firms of course will seek outside participation; some firms will wish to maintain their own Australian identity as well as the ability to control their own destiny.

This is also consistent with overseas patterns. After all, two of the most prominent New York based firms, Morgan Stanley and Goldman Sachs, are still wholly privately-owned.

Australian securities firms will no doubt seek to widen their role by undertaking not only agency work and underwriting but also block positioning and market making in selected stocks. They will also continue to introduce into the Australian domestic markets new financial instruments particularly those which have been successful in overseas markets. Two such instances which come to mind are cash management trusts and detached coupons in debt securities.

The structural issues which face dealers in the Australian industry are of course not unique to Australia. They equally affect smaller securities markets such as Toronto, Montreal, Johannesburg and the European markets. All of these Exchanges face the problem of reconciling a desire to participate in the international markets with a desire to retain both control and a separate identity in this most critical element of their activities.

Smaller overseas stock exchanges are not standing still. For example, the Boston Exchange, one of the smallest in the U.S., has been trying to attract more business by pioneering various activities. Recently it announced an electronic link with the Montreal Stock Exchange with the object of facilitating faster and cheaper trading of both U.S. and Canadian securities.

Summary

Exchange controls and restrictions on non-residents to invest in Australian securities firms have in the past tended to isolate Australian Domestic markets from the larger international markets. The lifting of Exchange Controls firstly in the U.K. and Canada, and finally in Australia in December 1983 has added a new dimension to the internationalisation of the Australian domestic securities markets. The realisation of limitations of size of the Australian domestic market will lead to a greater recognition of the need to see things more from an international perspective. The predominance in the securities markets of the large institutional investors, without doubt, will add to the increasing pressures upon the traditional methods of doing business in Australian markets, particularly in relation to secondary trading in securities of and fund raising for the larger Australian domestic companies. These are issues which might be laid aside for a further occasion.

Until very recently, the Australian domestic securities industry has been to a large extent protected by their own internal rules which imposed considerable constraints upon admission to the stock exchange. Now outside ownership has been permitted but government policies restrict non-resident ownership of a broking firm to any single institution to 15 per cent and to 40 per cent in the aggregate.

Recently, the Commonwealth Treasurer, The Hon. Paul Keating, announced that it was the Government's intention to review the existing restrictions placed upon non-residents and it is mooted that in the future, non-residents will be able to enter into the market to the same extent as Australian financial institutions such as banks and life assurance companies.

All this presents a formidable challenge to the Australian securities industry which faces the difficult task of working out policies which achieve a reasonable balance between the ability to retain a reasonable role for the Australian domestic industry on the one hand, whilst playing a significant role on the other hand when the larger Australian domestic companies seek to tap the international markets for their fund-raising activities.

Two of a number of matters which will need to be addressed stand out. One is the matter of conflict of interests. The Australian Stock Exchanges have moved a considerable way by the introduction of new Rules dealing with conflicts of interest, but inevitably new problems will be thrown up.

The second concern is to ensure that securities firms are adequately capitalised. As the Governor of the Bank of England recently said in an address to the National Association of Securities and Investment Managers:

> "A further concern will be to ensure that a securities house is adequately capitalised for the type of business that it is doing and the risks to which it is exposed. Functions such as broking and investment management are people-intensive rather than capital intensive; but other functions such as block-trading and market-making, which many more firms are likely to perform in future, require a much greater capital commitment. The securities regulator will need to ensure that the capital that is available to a firm is continuously sufficient in relation to the scale and nature of the business. A difficult set of issues will arise in determining the prudential requirements for financial conglomerates whose component parts are supervised by different authorities but where no regulator may be responsible for the group as a whole."

In raising these matters with you my intention is to initate an informed debate on a subject which is of crucial importance to this industry, to your Institute and of course to the Australian economy.