CONFLICT OF INTEREST

An Address by

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The Securities Institute of Australia has a long and honourable record in the business community, and has contributed in many ways to thinking about many aspects of Australia's business development. I am sure that you are mindful not only of that past contribution, but also and even more of the new challenges and opportunities that are opening up.

This presentation is about one aspect of those challenges and opportunities — the problem of conflict of interest. This is a problem that applies right across the business spectrum, but the leadership that the Securities Institute has shown in the past suggests that a constructive contribution to thinking about it may come from within your ranks.

Now there are some who would like to say to the NCSC that conflict of interest is a regulatory problem. You are appointed to regulate, go away and do it. We pay our taxes, why bother us with your problems. To those of that opinion, I say that I fundamentally disagree. The regulation of business should not be something that is done to the business community by an external regulator, but it is something that is done for the business community and to as large an extent as possible it should be done by the business community.

Let me elaborate by asserting three propositions:

1. The immensely complex world in which you earn your living depends on an equally complex framework of law and regulation. Without it you could not function, there would be chaos. May I remind you of the famous description of the lawless state of nature by the philosopher Thomas Hobbs. "In such condition there is no place for industry; because the fruit thereof is uncertain; and consequently no culture of the earth; no navigation, nor use of the commodities that may be imported by sea; no commodious building; no instruments of moving and removing such things as require much force; no knowledge of the face of the earth; no account of time; no arts, no letters, no society and which is worst of all, continual fear and danger of violent death; and the life of man solitary, poor, nasty, brutish and short."

   Well the world has changed a little since the early 17th century but the basic point is still relevant.

2. When the economy and the market are undergoing rapid change it is essential that the regulatory framework adapt to the changing needs. There are far too many examples of outdated, irrelevant and frustrating laws and regulations. It is in the interests of the business community that they be removed or changed, but it does not follow that we do not need new provisions to deal with new situations. What is needed is a readiness to discard outdated regulations that diminish business efficiency and replace them with regulations that facilitate the functioning of an efficient, honest and fair market.

3. The adjustment of regulations to changing market conditions is too complex and difficult to be left to governments alone. That does not mean that government agencies can be dispensed with. In the regulatory process they are necessary, but not sufficient. But if the regulations are to be useful to facilitate the working of the complex market, the involvement of the business community is no less necessary.

   This argument can be taken one stage further. The regulation of business in Australia has many strengths but many weaknesses. Certainly, it could be better. Many of its weaknesses are a reflection of the lack of involvement of the business community in times past, and while some of the blame for that lies with government, some must lie with a lack of interest and commitment by the companies and individuals of the private sector.

Against that background let me approach the problem of the conflict of interest, with the balance of this presentation divided into three sections. First, to recall some aspects of the problem, then to argue that it is becoming more serious and finally, to offer some thoughts about the ways in which we should try to solve it.

The Problem

First, the problem. Imagine for a moment that you are not experienced in financial matters, but that you have received a lump sum as a result of retirement or compensation and wish to invest it. You go to one of the hundreds of advisers who advertise their services. He is charming and understanding, he listens to your situation and recommends three attractive investment opportunities. Being prudent, you say you will sleep on his advice and talk it over with a neighbour who is employed by a company in the finance sector. He points out that the adviser's recommendations just happen to be the three things which offer him the highest commission. Your suspicions are aroused and you ask your neighbour what he would advise. He recommends three other investment opportunities which sound attractive until you realise that they are all products of the firm for which he works.

Consider again. You own 5,000 shares in Australian Amalgamated Enterprises, a well-known mining company. You decide to sell and take them to the brokers, Witherspoon and Snodgrass. The shares have been trading around $1.90 and you are amazed to read in the newspapers the next day that Metropolitan Megolomania has made a takeover bid and Amalgamated Enterprise shares have rocketed to $2.40 in heavy trading. The paper also says that Witherspoon and Snodgrass were the most active buyers on the day and presumably, bought shares in a range of prices from $1.90 to $2.40. About the time you are notified that your shares fetched $1.90, you learn that Witherspoon and Snodgrass bought heavily for their house account and subsequently sold a large parcel to Metropolitan Megolomania in the closing stages of the bid at $2.65.

Now suppose you are managing director of Supertech Microchips Limited, a rapidly expanding computer component manufacturer. Despite the fact that the world's slump in the late 1980's has finally pushed equity markets into a trough, your company's prospects are excellent and you need a major infusion of new capital. You approach your bank, Australis Gargantuan, which of course owns 50 per cent of Witherspoon and Snodgrass, now fallen on hard times. Your gearing ratio would justify an increase in your borrowings, but if your expansion continues, you will certainly need to raise more equity within the next two to three years. The depressed state of the market would make it extremely costly to raise equity at this time, but there are risks in your business and an equity issue would provide a valuable safety cushion for Australis Gargantuan's loans and besides, Witherspoon and Snodgrass have not underwritten a new issue for six months. What advice do you expect?

Let us take one final hypothetical case. Good times have returned and you are now in the investment advisory department of a multi-functional financial conglomerate. A large and long-established client telephones for advice and asks whether he should sell his Pacific Multi Metal shares. Their last results were uninspiring, but you remember that the chaps from the underwriting department with whom you shared a table in the canteen at lunch were talking with enthusiasm about a new issue to fund the Company's expansion into the USA. You heard something about a major technical breakthrough, the result of years of investment in research. What are you going to advise?

I hope these four examples will serve to remind you of the variety and complexity of the ways in which conflicts of interest arise. Before we go on, we need a definition and the simplest I have found comes from a recent UK Government paper. As you know, there is a major Bill before the House of Commons which will make substantial changes to the treatment of this problem. The UK definition is "a conflict of interest occurs where a practitioner's own interests conflict with those of a client, or where a particular practitioner has obligations to two or more clients. A business carrying on different activities or a practitioner having a duty to two or more clients, exhibits a potential conflict of interest which becomes an actual conflict needing resolution when one party to the transaction, either the practitioner or one of its clients can benefit over the other."

A potential conflict of interest may not by itself be harmful, but it can easily give rise to harmful situations. The Canadians are also vitally concerned with the problem at the present time and one of the most striking contributions to their debate came from Henry J Knowles QC who said in a recent speech "Conflicts of Interest are the initial cancerous cells that lead to the malignant tumours of self-dealing, fraud, embezzlement and theft." He called on the Canadian Government "to recognise the reality of human greed or self-interest and the natural law that conflicts of interest are almost universally resolved by self-interest."

Well that may be going too far, but there is no doubt that there is a great deal of international concern about the problem and I put it to you that the Australian business community should be giving it more attention.

The Changing Nature of the Problem

May I now pass to the second main part of the argument. The changing nature of the problem.

Why is there an increased concern in 1986? Essentially, it springs from the revolution in world financial markets which over the last few years has emanated from deregulation and the development of new technologies. One of the most conspicuous manifestations of this revolution has been the development of multi-product financial firms.

Already in Australia we have become conscious of a blurring of the traditional boundaries between financial institutions, banks are buying stockbrokers, insurance companies are selling investment products, and trustee companies are flexing their muscles and branching out into new fields. Recall if you will the annual reports of Australian banks, merchant banks, insurance companies and finance houses that you have read recently. How many of them remain in the traditional businesses that occupied their energies even five years ago.

The question needs no answer, but we in Australia have seen so far only a pale reflection of the developments in the USA and Canada. There the financial supermarket is already well established.

I was recently looking at the annual report of one of the largest New York stockbroking names. They describe themselves "as one of the world's largest leading investment and financial service firms". And they comment "as distinct client groups emerge, we tailor services to meet the particular financial goals of each market segment .... with investment flows becoming increasingly managed by institutions we use our capital and trading expertise to act as principal for institutional managers and to offer our market knowledge and distribution capacity to meet the demands of institutionalised markets .... as capital markets become increasingly globalised, our financial network offers issuers of securities and investment, direct access to the world's debt and equity markets. From varied personal financial services to tailored financing for corporations, to instantaneous trading opportunities for institutions our services keep pace with global market demands."

The report goes on to outline activities in many fields. These include buying and selling shares for clients, and as principal, underwriting, investment advice, cash management accounts, mutual funds, employee stock purchase plans, asset management funds, unit trusts, corporate financing, advising on mergers and takeovers, investment banking, real estate, both domestic and commercial, general insurance, life insurance and a joint venture with IBM to promote an advanced information system. One is tempted to add "and Uncle Tom Cobbly and all". That is not meant to be a complete list but it gives some ideas of the wares of one of the new financial supermarkets.

That broking institution reports that "a stunning transformation is taking place in financial services, spurred by regulatory change, technological innovation and economic forces, capital flows are global, instantaneous and highly volatile."

I think you will agree that Australia must expect a great deal more change in the direction of the financial supermarket than we have yet seen and the breakdown of the traditional demarcation lines will bring with it many more potential conflicts of interest.

Conflicts of interest have always existed in the securities industry, but the tendency to specialise in particular activities has kept them in check. The rules of stock exchanges and of professional bodies have been a reasonably effective control. Traditional concepts of professional responsibility and even the old-fashioned idea of honour have reassured clients.

But times are changing, a new generation is beginning to dominate the financial world. New criteria of success are emerging, and new standards of behaviour are becoming accepted. The old demarcation lines are breaking down and I am reminded of Dr Johnson's remarks that "the power of doing wrong with impunity seldom waits long for the will". Regrettably, we can no longer rely on the protections that were adequate even in the last decade. Unless there is an improved response to the new challenge Henry Knowles warning about the triumph of self-interest will be fulfilled and the international reputation of Australia's financial markets will be besmirched.

What is to be Done?

Let us now turn to the third part of the argument and ask what is to be done?

For many people the first response to talk of conflict of interest is to mention Chinese Walls, so let's start with them. We need a definition and once again the British Government background paper on conflict of interest provides a good one. "Chinese Wall means an established arrangement whereby information known to persons involved in one part of a business is not available (directly or indirectly) to those involved in another part of the business and it is accepted that in each of the parts of the business so divided, decisions will be taken without reference to any interest which any other such part or any person in any other such part of the business may have in the matter." Chinese Walls are well established, not only in Australia, but in the USA, Canada and the UK. In this country they are established to a greater or lesser degree in many, but not all stockbrokers, merchant bankers and other financial institutions. They are a valuable protection for the firms that have them and they go some way to protect the clients from the consequences of conflict of interest, but they are not enough.

I have recently been perusing some of the NCSC files on conflicts of interest and have come across a number of instances in which there have been complaints against a firm, or in which the NCSC officers have had cause to be suspicious about a firm's behaviour.

In one particular case, a merchant bank advised a company on a takeover and it turned out that just before the offer was made another department of the merchant bank had bought a large volume of the target company's shares on the market so that the bank had a substantial parcel available when the bid was announced. That parcel was sold to the bidder during the course of the bid and was a significant factor in its success.

In answer to our question, the merchant bank claimed that its independent investment department had formed a separate and distinct judgement that the target was a good investment prospect for its investment funds. It also claimed that it had installed adequate, indeed elaborate Chinese Walls, that would have effectively prevented the investment department from knowing about the discussions going on in another part of the firm that led to the takeover bid.

We received signed assurances on both points. They were plausible and we accepted them, but I am left with an admiration of the business judgement and timing of the investment department and a vague sense of coincidence. I cannot honestly claim that instances like that give me much confidence in the Chinese Walls installed in Australia today.

Perhaps the last comment on Chinese Walls should come from Professor Gower, the architect of the new British Securities Industry Plan, who said he had never seen a Chinese Wall without a grapevine growing over it.

Well if we can't rely entirely on Chinese Walls, what shall we do? A full disclosure of interest is probably the most useful single way of protecting the client, but to be effective it needs to be not only full and fair, but also to be made in such a manner that the implications are understood particularly by the less experienced clients. There are three essential types of disclosure:

1. The existence of any material interest in the transaction;
2. The capacity in which the practitioner is dealing;
3. The amount of any commission charged or profit receivable.

You will readily see that if there had been full disclosure under each of these headings, the client in the first of my hypothetical examples would have been in a much better position. Disclosure provides a valuable protection, but I regret to say that many financial organisations in Australia today do not provide anything like an adequate coverage of the three categories I have mentioned. You will be aware that the NCSC recently laid down requirements for much fuller disclosure for listed property trusts and that there are now pressing complaints about the unfairness of not extending the same rules to insurance bonds. That is only one of several similar problems that must be faced in the near future.

Another important way in which the possible adverse effects of conflict of interest can be avoided is by rules governing the resolution of conflicts. A recent British White Paper on the securities industry sets out two principles which are of considerable interest.

> "1. A best execution principle whereby all instructions from clients must be executed to a client's best advantage, thus no investment business should deal with a client from its own account or book, unless this would result in better terms for the client.
>
> 2. A subordination of interest requirement so that the client's interests are paramount, thus clients should be given priority in the execution of orders when an investment business is also dealing on its own account and there should be no churning of a managed portfolio to generate commission income. Transactions should not be carried out except at the price in the volume and at the time indicated, and in accordance with the wishes of the client where these have been expressed."

Our own stock exchange rules go some way towards these principles but it may be necessary to develop the concept further and apply it more widely in Australia.

So there are at least three ways in which the problem of conflict of interest can be contained: Chinese Walls, disclosure and rules for the resolution of conflict. They are not meant as a comprehensive account of what is possible but as an indication of the complexity of the problem.

Just as conflict of interest can arise in many ways, at the interfaces of many different types of activity, so the threats that arise from them can be dealt with in different ways. The law, the regulation and the practices affecting conflict differ between the USA, Canada and the UK and as the financial markets change, so they are changing.

There is no settled solution apparent that can be offered for Australia, but I would like to put forward our four propositions:

1. It is in the interest of all the financial community for our markets to be perceived as efficient, honest and fair, by investors both at home and overseas. They cannot be so perceived unless the problem of conflict of interest is seen to be dealt with fairly and reliably.
2. As financial markets change, and in particular as multi-functional firms develop, the problems of conflict of interest will become more complex and more difficult.
3. The laws, regulations and private sector rules presently in force in Australia and the practices currently followed may not be adequate to cope with the problem as it now is and unless they are brought into line with changing market needs the credibility of our financial institutions will be threatened. We stand at risk of being seen to be engaged in sharp practice.
4. The smaller the role of government in regulating the private sector practices the better. I fear it would be too vain a hope to imagine the private sector dealing with the problem unaided, but I would greatly prefer solutions like stock exchange rules, with the private sector taking the main role and the NCSC providing back-up to a situation in which prescriptive legislation was necessary. But if the private sector does not adapt, some form of additional regulation will be necessary.

In view of the long and honourable record of the Securities Institute in this country, and your deep reserves of experience, is it possible to hope that members of your institute can play a role in helping our financial community to adapt to the new challenge?

APOLOGY

In the April 1986 edition of JASSA, several typographical errors were present. The standard of presentation of that issue was below the standard regarded as satisfactory for the publication of JASSA and an apology is extended to readers accordingly. The publication process for JASSA has been revised, and every effort is being made to ensure that the current and all future issues of JASSA are published to the appropriate standard of presentation which SIA members and readers have come to expect.