THE NEW AGE OF SHARE-TRADING

WILL SEATS MEAN THE END OF THE BROKER?

by EDNA CAREW

Screen trading has arrived, but not without controversy and uncertainty. Some critics lament the loss of the 'human element' as stockbroking undergoes its most sweeping change.

Screen-trading is changing stockbroking as we know it. The question that haunts the brokers, though, is not merely whether screen-trading will change their lives, but whether it will end their livelihood.

The birth of SEATS (Stock Exchange Automated Trading System) caused a schism within the industry, a development that few would wish to encourage and which the Australian Stock Exchange (ASX) has been moderately successful in defusing. But while the debate about the desirability or otherwise of screen-trading has flourished across the industry and across the nation, the new system has become reality rather than a futuristic prospect. The real question now hinges on the continued speed of implementation and further progress.

SEATS went live – with a bang – on October 19 1987, at the start of a week that saw the Australian stockmarket shed 40 per cent of its value as a victim of the worldwide collapse in share prices. Supporters of the system say it earned its stripes that day, proving its worth in a volatile and hectic market and offering advantages over a congested and panicky trading floor.

SEATS' critics point to a more recent event: in July the system went down for the better part of a day, with many brokers angry at the domestic shambles and the loss of image internationally. A further irritation for the SEATS camp was the absence of the "hot" back-up system which was not at that stage ready to fill the void. This provided additional ammunition for the detractors. Pro-SEATS brokers say it was a hiccup that left everyone caught in the same traffic jam and is now forgotten; the anti-SEATS lobby threatens that a repeat experience would be met with direct broker-to-broker trading. The SEATS proponents retaliate by citing a day when chalkies on the Melbourne trading floor failed to appear – flaws occur on the floor too, they say.

All but a few hundred company stocks are now listed on SEATS. The ASX is still discussing the possibility of having all stocks on the system by the end of this year. This target, though, will be reviewed and modified in the light of experience, and a decision is more likely in 1990. For this involves one of the most contentious issues: whether the most-active stocks should be traded on-screen or left on the trading floor. Many believe that some stocks should be left on the floor, possibly as many as the 150 most-active stocks. Supporters of this view point to the Japanese experience: there, about 85 per cent of stocks are screen-traded but the 15 per cent that are traded on the floor account for the lion's share of the action.

Brent Potts, of Potts West Trumbull, a long-standing, though no longer lone, opponent of electronic screen-trading, believes there is a finesse required on the trading floor that is impossible to replicate using a screen. "It is that finesse that the client pays for, and which earns the brokers their commissions," he says.

Edna Carew, a Sydney-based writer, is the author of several books on the Australian financial system.

"Screens turn the market into a supermarket, with shelf products."

Clive Batrouney, deputy managing director of ANZ McCaughan, points out that business is created on the trading floor, through the interaction of the brokers, in a way that could only be facilitated if screens were supplemented by an information and communications network. Batrouney concedes that progress means the market has to adjust to an electronic system which works well, but baulks at the prospect of the market becoming clinical.

"Broking is not clinical business," he says. "It's very personal, involving broker-to-broker and broker-to-client communication. That's important to the market." And he adds that the successful brokers in recent years have been those who are good on the trading floor.

ASX managing director Gavin Campbell agrees that there is an "instinctive feel" that some stocks should be held out of SEATS, possibly the top 50 or 100, because the personal element cannot be adequately captured by the system. He adds: "That has not been proven either way. But we will find out. The marketplace will ultimately determine the most sensible system."

In Campbell's opinion, the real question to be resolved is whether SEATS can do an adequate job in a way that satisfies all public interest dimensions. To that end, he says, the ASX is testing all aspects of the system. "We are determined to get it right," he says. "We must not introduce SEATS in a way that damages market liquidity – we hope it will increase liquidity. But people are right to insist that permanent change be thoroughly researched."

Those who believe the screen gives away too much say it is akin to playing poker when others can see your hand. And that, they say, is not in the best interest of the client. The trading-floor skills which have been developed over the past two centuries involve a human element (and a degree of theatre and colour) which, many believe, is lost with the introduction of a trading screen. And that loss, they say, is as much to the detriment of the client as to the broker.

SEATS' critics point to what the broking industry, in its present form, can provide: an efficient form of capital raising and, free of direct charge, a huge volume of research. Brokers could not provide these services if they are to be deprived of commissions, as some fear will happen as SEATS progressively reduces the brokers' role.

ASX managing director Gavin Campbell: "The marketplace will ultimately determine the most sensible system."

The electronic screen-trading system that has been introduced in Australia has drawn on the CATS (Computer Assisted Trading System) of Canada but has used the more advanced technology now available to build a faster and more sophisticated system. The result is a powerful system that puts Australia ahead of London in the electronic trading league.

In the opinion of Charles Moore, managing director of Jardine Fleming Securities Ltd, we have delivered ourselves technology which has "over-achieved". He says: "Look around the world and no-one has the degree of electronic efficiency of the ASX. The Canadian system was the genesis but has been refined and improved. London's system shows the markets on screen but the dealers have to deal by telephone. In Australia the market is on screen and deals are made by the touch of a button."

Moore is one who cautiously supports screen-trading because of the competitive pressures of the market and the need to develop the most efficient system available. In his view, screen-trading is more efficient during boom times than the trading floor.

For the broking industry, the SEATS system challenges a number of cherished traditions, such as the confidentiality of what they regard as market-sensitive information. While by-and-large accepting the premise that an informed market is an efficient one, many in the industry draw the line at clients being able to receive detailed information about the level of particular brokers' activities.

Batrouney speaks for many when he says that details of the market should not be revealed to clients. "It is fine for the institutions to have general information but a market is not a market if you bare all, " he says. "You need to retain some edge."

The spread of information through SEATS, as well as the nationwide spread of business activity, is one significant plus of the system for the smaller exchanges. Hence the popularity of SEATS with Perth, Brisbane, Adelaide and Hobart. Thanks to SEATS and the federal nature of the ASX, these exchanges participate in the national market to a far greater extent than they could in the days of trading-floor activity only.

What is welcomed by the smaller exchanges is regarded by Sydney and Melbourne as a situation where the tail is wagging the dog. The four smaller exchanges have 40 per cent of the vote but, as the brokers in the larger cities are quick to point out, represent a mere five per cent of the market. SEATS has enabled the brokers in the smaller exchanges to participate directly in the market, whereas in the past they had to pass an order through to a broker in, say, Sydney or Melbourne.

So while a recent Morgan poll showed that brokers in Melbourne and Sydney were 2:1 against screen trading fully replacing floor trading, the brokers in the other four centres were 4:1 in favour of ceasing floor trading entirely by the end of the year.

Even those who have opposed screen trading agree that the move is inevitable, given the general spread of technology in all areas of business and the internationalisation of financial markets. The stock exchange has never had a reputation for being at the vanguard of change. Whereas the banks in Australia embraced deregulation early in the 1980s, the exchange did not move to dismantle traditions such as membership status and fixed rates of brokerage until 1984. London's "Big Bang" came in 1986, long after the City banks had learned to live with competition.

Those reluctant to embrace screen trading concede that the battle may be over, but they do feel there are some genuine points to be made in the interests of achieving an efficient market, one that not only ensures a continuing role for the brokers but provides a good service to their clients.

Areas commonly cited as potential weaknesses in SEATS are the system's ability to cope with the most actively traded stocks and its capacity to service option trading. Brokers' fears that they could be rendered redundant by full-scale screen trading are not reflected in the views of the institutions who generally forecast a continuing role for the efficient intermediary who can add to the institutions' pool of knowledge.

Merv Peacock, manager, Australian equities, with the AMP Society, is one institutional player who believes the brokers' fears are unjustified. "You need to get an independent view of stock and brokers provide that service," he says. "Despite having your own research, you draw on the research of the brokers. And you can't expect that information without remunerating the brokers [through commissions]."

Bruce Bell, senior investment manager with National Mutual, says his company is not convinced that SEATS represents a step forward in efficiency over the physical market place for the actively traded stocks. "But we are interested in anything that leads to more efficient execution. And we would be comfortable if the exchange maintained the trading floor for the 100 most active stocks," he says. "We see a real role for intermediaries where genuine value is given, not just a slap on the back."

Apart from the spread of information with SEATS, there is concern, among the institutions as much as among the brokers, to preserve the anonymity of market players. Australia is not the US, where a large institution can come into the market in volume without its competitors being quickly able to identify the player. Bell agrees that anonymity is important but does not regard it as a major issue. Peacock believes that anonymity is very important, and would be lost if players traded on their own account.

There is virtual consensus among brokers and institutions alike that the low-volume, less-active stocks should be traded on the screen. There is widespread agreement among the market-users that the active stocks, particularly those linked to options, should remain on the trading floor. Frank Favretto, director in charge of BT Stockbroking, speaks for many when he says that SEATS is very negative for the options market, and that option stocks should be kept on the trading floor.

Brent Potts cites the priority system of SEATS (which is still being refined) as a big hurdle. "The priority system inhibits traders' ability to carry out options transactions where the option stock is listed on the screen," he says, "because the trader can't always get the stock at the price."

The priority system of trading as it was originally presented in SEATS allows the first bid or offer to handle all transactions until satisfied. First-in, best-dressed. The priority system has sparked vigorous arguments. Some believe it is fair in that it allows whoever is prepared to make the price to get the trades; it is not possible with SEATS, as it is on the trading floor, for some operators to hang on the coat tails of the bigger brokers because all equal bids or offers share equally in sales. Others claim the priority system increases the volatility in prices, as whoever follows the first-in has to make a new price.

Extending the notion of fairness and sharing of trades, it has been suggested that the crossing rule (transactions above a threshold of $500,000 need not be exposed to the market) be varied. A compromise had been proposed, along the lines of offering some 10 or 20 per cent of the order to the market after the rest has been satisfied.

Australian institutions are happy to see the arrival of SEATS as an extension of, and improvement on, the existing system. They are in favour of retaining the brokers as intermediaries who ensure anonymity and who provide research and market intelligence that supplements the institutions' own database. Some institutions have broking arms (though they do not necessarily deal through them). The institutions are happy to make use of any additional market information that SEATS might provide but do not necessarily wish to take out ASX membership themselves.

In the short term, the brokers worry about wrinkles in the SEATS system, its ability to cope with areas such as options, the pros and cons of the priority system and whether the screens will prove adequate to the challenge of hectic trading in consistently active stocks in a bull market.

On a wider scale, though, there is another ingredient in the SEATS argument which unnerves the brokers, and that is the infiltration into their turf by the banks. Banks enthusiastically bought into broking firms when the exchange relaxed its membership rules in 1984. Not all the bank-broker marriages have proved happy or even profitable, particularly since the October 1987 crash and lower market turnover. But internationalisation of markets and the need, in a competitive market, for a solid capital base, leave the brokers receptive to the bankers' embrace.

Banks are spending hugely on investment in technology and are unlikely to leave their securities trading arm out of the drive to improve their functions electronically. On this score, Charles Moore predicts the inevitability of *all* functions within the broking industry going electronic, including settlement, registration transfer.

Many within the broking industry

are unsettled by the prospect of bank tentacles extending further, with the bankers' push for technology taking the human element out of broking. Brent Potts views screen trading as a significant stage in this process. "Screen trading is likely to drive brokers out of this industry, and it will be left to the banks," he says.

This comment reflects more than merely a concern about brokers' livelihood – there is a mounting resistance to the prospect of banks in Australia achieving the same kind of grip on financial services that is enjoyed by the large "universal" banks in West Germany. It is hardly in the interests of a healthy competitive market if the major capital-raisers are also the major lenders. That would seem to produce a concentration of power that goes against the philosophy of a deregulated market.

In this context, the brokers frequently cite the experience with fixed-interest trading as a possible precedent for what could occur in equities. Ten years ago underwriting and trading in fixed-interest securities, such as Commonwealth bonds and semi-government paper, was the preserve of the big broking firms. Over the years, though, the increasing size of the issues and the spread of money-market screen trading brought in the merchant banks and particularly the banks, to the growing exclusion of the broking firms. There is a fundamental difference, though, between the homogeneous fixed-interest product and the widely differing nature of shares, and many believe this counters the possibility that equities could follow fixed-interest out of the brokers' hands.

No discussion involving electronics and share trading is possible without a mention of the need to improve the market's settlement system. Opinions may vary about the merits of SEATS but there is widespread agreement that the market would benefit, domestically and in terms of international participation, if the settlement system were upgraded. The recently implemented FAST (Flexible Accelerated Security Transfer) system is an improvement but is still paper-based and widely regarded as a patch-up. It would seem logical that a system such as Austraclear, which clears electronically for the money market, could have a role in the electronic settlement of equities, adapting what it has achieved with, say, bills of exchange to settle shares. □

ENTER INSTINET – A NEW CHALLENGE?

It never rains but it pours. While the ASX is still testing and refining SEATS, against a backdrop of brokers' resistance, Reuters has sought approval to introduce Instinet, its equities screen-trading system, to Australia.

Instinet, which was functioning as a broker 20 years ago when Reuters bought it, has more than 1,000 subscribers in 14 countries who use the system to trade US and UK securities. Traders retain their anonymity. In the US, Instinet is registered as a broker with the Securities and Exchange Commission (SEC) and is a member of the National Association of Securities Dealers (NASD).

Reuters has asked that the National Companies and Securities Commission (NCSC), like the US's SEC and the UK's Securities Industry Board (SIB), acknowledge that Instinet is a broker, different from other brokers only in that it uses technology to provide service. The NCSC is examining, among other aspects, whether Instinet would provide adequate protection of Australian public interest. The NCSC is taking into account the information gleaned during its recent overseas trip (undertaken with the ASX) which included discussions with exchanges and regulators in North American and European centres.

Instinet is making progress in Japan, where the Ministry of Finance has approved the introduction of the system. A few months ago, in June, Instinet won agreement with the Toronto Stock Exchange to become a member of the exchange and operate as a securities dealer, with a view to establishing its electronic network early next year.

The Canadian win is encouraging to Instinet, which faced similar problems in Canada to those confronting it in Australia – ie, a fairly hostile domestic market of brokers who see Instinet as yet another threat to their future. Instinet does not see itself as likely to make brokers redundant, or as being in competition with the ASX.

Scott Thornton, Reuters' chief representative in Australia, emphasises that SEATS is a domestic system and Instinet is internationally oriented. Instinet does not intend to offer brokerage services in stocks listed on the ASX unless they are also listed on overseas exchanges to which Instinet provides access. And Instinet serves only the professional, rather than retail, market. Some locals, however, read Instinet as a threat, believing it could extend its focus once established.

Reuters has applied under the Securities Industry Code for Instinet to be authorised as an "exempt stock market". This is necessary under Australian legislation, and is not a new concept – Telerate and AAP-Reuters are examples of existing exempt stock markets, being facilities that permit the display of orders to buy and sell securities.

As a member of ASX, Instinet would be bound by the exchange's rules. Reuters does not guarantee the settlement of Instinet trading but closely surveys the brokers and others who use its system. "Instinet creates a marvellous audit trail – the system shows what has been done when," says Thornton. Instinet is happy to interface with SEATS – it does not yet interface with CATS in Canada but that is under discussion. As Thornton says, Reuters, being an international news and information service, has a reputation for maximum disclosure in markets. "We have no interest in closed clubs," he says.

As for the brokers' fears, Thornton says Instinet has not put any brokers out of business. "There will always be a need for good brokers – they do more than just execute trades," he says. Instinet takes about 3 per cent of business volume in the US and Europe, though Thornton does not agree that traders prefer the floor to Instinet for the "big-lick" trades. Figures showing that 95 per cent of Instinet trading in the US involves a broker at one end or another substantiates his view that brokers find the system of value.

What about the comparatively smaller Australian market? Thornton says Instinet could add to liquidity here by boosting international activity in Australian stocks. "We have come to Australia because it is part of our international network. There is still big interest in Australia as a financial centre," he says. □