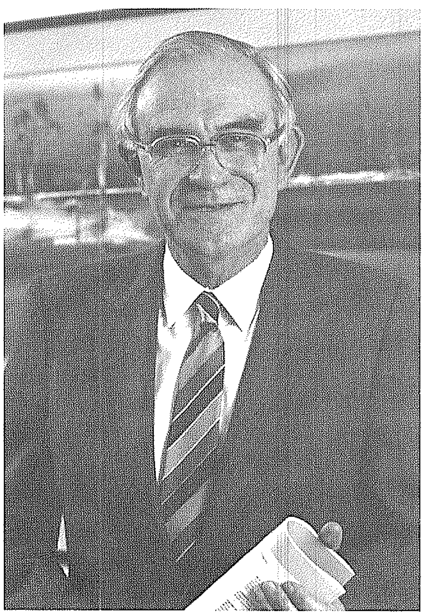
RULES FOR THE HONEST BROKERS

HOW FIRMS CAN KEEP THE LID ON GREED



by BRIAN FRANCE

Users of securities markets need reassurance that their affairs are in the hands of honest men. One way is for broking firms to institute rigorous in-house codes of conduct.

In any securities market one expects to find a mix of people who can be classified as **owners**, that is, ultimate beneficial owners of securities who buy and sell, including investors and others such as management buy-out groups; **advisers**, such as lawyers, accountants, geologists, engineers, bankers, stockbrokers, property valuers and anyone likely to become a consultant for a prospectus, takeover document or memorandum of offer; **capital originators**, that is, companies seeking to raise debt or equity capital; and the **regulators**, that is, the NCSC (soon to be replaced by the ASC), the corporate affairs commissions and the Australian Stock Exchange (ASX).

There is also a group who could be defined as **the alert fringe.** These are not professionals but they include anyone with eyes and ears such as chauffeurs, couriers, waiters, hairdressers, masseurs – all people who might come into contact with price-sensitive information.

To mention this range of people is not to imply any lack of integrity among them, but to emphasise just how wide the circle of knowledge can be when we are talking about price-sensitive information.

Any of these people or groups of people can have access to price-sensitive information and many, but not all, would know how to try to turn it into personal gain. The stockbroker is just one of the many people who will expect to possess inside information. So why are brokers so often singled out to explain how they handle the problem of price-sensitive information within their own firms?

In the United States, insider trading has been uncovered on a spectacular scale and most of the cases have involved stockbrokers. With that kind of publicity on the record, society may well ask what stockbrokers in all parts of the world, including Australia, are doing to ensure compliance with the laws relating to market malpractices – of which insider trading is just one. Other malpractices are market-rigging, front-running (i.e., when intermediaries execute orders on their own behalf ahead of their clients) and failure to disclose to the market large share dealings as required by law (as in the Blue Arrow case in London).

Stockbrokers are intermediaries – that is, they deal in securities for beneficial owners – but they may also act as principals and often do, although in Australia most of this principal dealing is "client-driven" in the sense that brokers own securities in their own right for a short time so as to facilitate the execution of client orders.

Brokers have research analysts whose job it is to probe and dig in their quest for information about the future direction of listed companies. Most of the larger brokers also have corporate departments which are in possession of highly confidential information entrusted

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to them by clients.

This all means that stockbrokers *are* subjected to price-sensitive information by virtue of their role in the securities industry and must demonstrate to the regulators (stock exchange, NCSC, CAC), their clients, their own staff and to all users of the market that such information can be handled discreetly and efficiently – in the same way as we all expect high explosives to be handled by those responsible for that function. The analogy continues to the statement that one bad mistake can be expected to make a terrible mess of either expert.

Clearly the possession of highly confidential and price-sensitive information is not an offence; business in securities markets simply would not function if such information were not entrusted to people. Our concern is that such people do not try to use that information for the personal gain of themselves or their associates. Greed appears in the most surprising places, as we are being reminded by revelations in stockmarkets here and overseas.

What follows is a list of suggested rules a stockbroker might adopt if he is to protect his firm and its staff under current laws – not only those relating to insider trading but to other market malpractices as well.

New employees: All new employees should be made aware of relevant legislation including stock exchange rules. Preferably an in-house set of "employee dealing rules" should be explained and given to the employee who acknowledges the receipt of them. However, making employees "aware" of legislation is only a beginning to the education process. At least they will also be aware that the firm's management is committed to compliance with the law.

Breach of rules: All employees must be aware of the consequences of breaching the rules and the law. Insider trading is a criminal offence in Australia and carries penalties of fines and imprisonment and loss of licence. But we know that the existence of rules and law will not dissuade those people who are inclined to commit criminal offences in the pursuit of personal gain.

Dealings in the market: Some stockbrokers prohibit all dealings in securities by staff. This might be seen by many as unnecessarily restrictive in an industry which believes in people investing their savings in Australian companies. The alternative of permitting employee dealing in securities necessarily involves a fairly extensive set of "do's" and "don'ts".

Prior permission: Before an employee (including a director) deals, the employee must obtain written permission of the compliance officer or someone authorised in his place. This is also a stock exchange rule.

Speculation: Speculative dealing and excessively frequent dealing by employees should be discouraged. In this way investment is encouraged ahead of speculation which may be related to market gossip and could bring the firm into danger zones.

Influence by employees over a security: Unless the employee has prior approval, he must not deal in a particular security if he could reasonably be thought to be:

- associated with the security;
- able to exercise any influence over the price of the security; or
- in possession of confidential information relevant to its price.

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For example, if a research analyst is an expert or recognised in the market as the "guru" on a particular stock, he should not deal in that stock at *any* time. Where an employee believes that any of these conditions apply he should notify the compliance officer when seeking permission to deal in that security.

Corporate finance rules

Corporate finance clients' stock – prior permission required for dealings: Before an employee, or any connected person, deals in any securities of a client of the corporate finance division, or of any other company in a confidential relationship with the division, permission must be given by the head of division and the compliance officer.

An employee who is not a member of the corporate finance division should be deemed to be a member of the division if he is working with it (or has done so) on a specific operation, for example, on a takeover bid or rights issue, or is so close to a client of the corporate finance division that the client may be expected, from time to time, to entrust the employee with confidential information.

Corporate finance clients' stock – three-month retention rule: An employee must not sell a security of a corporate finance client until three months after he has purchased it. This rule is intended to prevent active trading in the stock of corporate clients. It does not affect the operation of the other rules once the three months have elapsed.

Details of all corporate finance clients must be available from the head of the corporate finance division.

Corporate finance clients' stock (publication of results) – two-month rule: An employee must not deal in a security of a corporate finance client in the two months immediately before the expected publication of its interim or final results for any period, except under specified circumstances.

Details of the expected dates of result announcements by corporate finance clients should be available from the head of the corporate finance division.

Corporate finance clients – takeovers, mergers, capital reconstructions, acquisitions: If a corporate finance client is involved in a publicly announced takeover, merger or capital reconstruction, or an acquisition or disposal of assets which is subject to shareholders' approval, or has announced a rights issue, employees must not deal in any of its securities, or, in the case of a takeover, merger, acquisition or disposal, any securities of the other party.

In-house surveillance

These are just a sample of "in-house" rules which a broker might adopt and ensure a full understanding of them by all staff. But the existence of "in-house" rules and the formal acknowledgment of them by employees are not enough. It will be necessary for the firm to have "in-house" monitoring of employee dealing and its relationship, if any, to the firm's research publications and corporate work. The bigger the firm, the more such "in-house" surveillance will require effective systems.

Much is said about "Chinese walls" and possibly a good deal less understood about what they are and what they are supposed to be achieving. Certainly a stockbroker's corporate department should be inaccessible to other staff. This is easily done by security doors.

Sometimes staff other than corporate staff will be required to assist behind the Chinese walls: they should be "quarantined" and remain there until their task is completed and they are released by management.

Firms which have established Chinese walls will know that these alone will not provide the total security that is necessary in a stockbroking office. Senior management will always need to be kept informed of what the firm is doing and more important, is about to be doing. No system of security, whether inside Chinese walls or by detailed in-house rules, will ever be safe without 100 per cent integrity on the part of all staff, as well as commonsense and judgment.

There is a danger that encouraging excessive confidentiality will lead to the type of secretive behaviour that apparently existed in certain well-publicised events in London in recent times. Good internal communication must co-exist with the secrecy provided by Chinese walls. This can be achieved by having transactions reviewed by peers, an operations committee or even the compliance officer.

Stock exchange surveillance

Closely related to the stockbroker in dealing with insider trading is the Australian Stock Exchange (ASX) and it is as well that we have a truly national ASX, not only for dealing systems and accounting, but for national surveillance. The Surveillance Division of the ASX was set up this year with headquarters in Sydney under Mr Jim Berry.

Its function is to initiate inquiries with all markets operated by the ASX and it is developing working relationships with surveillance divisions in such markets as Hong Kong, the UK and North America. The surveillance function must be able to follow the trading markets, which are themselves international. To do this they will have to build a strong professional relationship with their opposite numbers in other stockmarkets.

The aim of the ASX Surveillance Division is to provide the NCSC, the ASC or the ASX Membership Division with indications or evidence of market offences. It is expected to provide effective self-regulation and to improve the public perception of the markets traded by ASX.

We must surely get the message that society is in hot pursuit of unacceptable behaviour in our stockmarket.

Brokers' duty

This leads us to the question of whether brokers have any duty to alert the NCSC or ASC to illegal conduct by clients which is unrelated to internal leaks of information or misconduct by the brokers' employees.

For example, what is the duty of a broker who suspects his client is dealing in the market with price-sensitive inside information? Further assume that this inside information has come to his client from a source quite unrelated to the broker's firm. Should the broker alert, say, the NCSC or ASX? Or should he rely on his broker/client relationship and say to himself, "I suspect very strongly that this large order results from inside information but my duty is to my client and market surveillance is the job of the authorities"?

Mr Ray Vass, director of compliance for Merrill Lynch, New York, addressed this question in a forum on the prevention of insider trading arranged by the US Securities Industry Association in New York on June 23, 1987.

He said that "we must always focus primarily on our first responsibility; the internal control of our own business and employees". He also said "to the extent that the systems and procedures designed for this purpose enable us to detect possible indicators of misconduct on the part of *non-employees* (including customers), our firms and the industry are served well".

Mr Vass then addressed the broader question and concluded that "(broking) firms should disclose their concerns to appropriate regulatory or law enforcement entities when, in the best judgment of experienced personnel, it appears likely that substantive violations have occurred".

In a few words, Mr Vass was saying the broker *does* have a support role to the authorities in the detection of insider trading among people who are not staff, but that role should not go as far as setting up systems and procedures in addition to those set up for the surveillance of the broker's own staff.

Insider trading, market rigging and other malpractices are criminal offences in Australia and some other countries with well-developed securities markets. Add to that the growing call for "corporate morality" being heard from various groups (including a consistent voice from the NSW Bench) and we must surely get the message that society is in hot pursuit of unacceptable behaviour in our stock market.

Stockbrokers, because of their function in this market – buying and selling shares, underwriting, acting for offerors and offerees in takeovers, advising on privatisation, management buy-outs and capital structures – are always in possession of confidential information. But this does not make stockbrokers unique: lawyers, accountants, doctors, company directors and politicians are also entrusted with confidential information and society expects they will not turn such a trust into self-interest.

I believe stockbrokers must try harder than some other professionals to show society that they really do condemn such malpractices as insider trading.

They will do this by setting up rules and procedures within their own firms which must be observed by staff; offenders should be dismissed and possibly reported to the authorities as well.

They will do this by actively supporting the ASX in its national surveillance and the NCSC/ASC in its administration of the law.

They will do this by having regular meetings between the compliance managers of the leading broking firms so as to share experiences and surveillance systems. Brokers tend not to talk to each other enough in the interest of sharing experiences – compliance is one area where they should.

Finally, there is the "good corporate citizen" role. Should a broker "dob-in" a client who he believes is in breach or attempting to be? I do not think the answer to this is a blunt "yes" or "no". I prefer the conclusion of Mr Vass from Merrill Lynch when he gave a qualified "yes" in saying "when, in the best judgment of experienced personnel, it appears likely that substantive violations have occurred". ☐