THE A TO B OF OUR TWO STOCKMARKETS

HOW REGULATION AFFECTS BIG AND SMALL

By THOMAS E. HEADRICK

High liquidity in the Australian stockmarket is confined to a relative handful of companies. Will new regulations re-draw the line that separates the market segments?

The Australian stockmarket is part of the instantaneously connected global financial system. Conveniently located in the world spread of time-zones, and blessed with familiar and comfortable business and legal customs, the Australian market attracts worldwide investors. Although not large when compared with the major markets, it has a capitalisation in the $200 billion range and a broad list of more than 1,300 main-board stocks to command the attention of investors.

Because the Australian Stock Exchange (ASX) appears to operate not as one integrated market, but as two or more segmented markets, it is worth asking whether the regulatory structure, which generally subjects participants in the market to the same or similar requirements, is appropriate. Does this regulatory structure assist and encourage the integration of Australia into the global market? And does it encourage economic development at home?

Despite the relatively healthy capitalisation and reasonably extensive range of listed stocks, the market is much smaller than it appears. The figures for the year ending 30 June 1990 contain some interesting information. Nearly half (47 per cent) of the market capitalisation resides in 25 companies; that is, less than 2 per cent of those listed. This proportion has risen steadily since 1987 when the top 25 constituted less than a third of the total market. Given the structure of the Australian economy and the extensive reshuffling in the 1980s, this significant concentration is not surprising; the extent of it, however, probably is.

The trading is even more concentrated. In 1990 the 25 most-actively traded stocks, which included 22 of the top 25 companies (by capitalisation), accounted for nearly 70 per cent of the trading value. In 1987 the comparable figure was 40 per cent. Just for emphasis, 2 per cent of the listed stocks constituted 70 per cent of the trading value and 98 per cent made up the remaining 30 per cent. No doubt if figures were found for trading in the top 50 and top 100, they would account for the lion's share of this remaining 30 per cent.

Again, some concentration, as measured by these calculations, is to be expected, but it remains that slightly less than 50 per cent of the capitalisation provides 70 per cent of the trading value. In the present economic environment, the ASX is a rather tight market.

This intimacy carries through to the traders as well. At June 30, 1990, the ASX had 106 members. The membership had increased by two during the previous year but was still below the high-flying days of

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1987. What is striking, however, is the concentration of trading in a few members. Ten members accounted for more than two-thirds (68 per cent) of the trading in the 1989/90 year; in the previous year, the top 10 accounted for 63 per cent of the trading; in 1986/87, 56 per cent. That is not to say that 10 per cent of the brokers control the majority of the trading business and the other 90 per cent live off scraps. But it does raise some questions about the nature of the market and the participants.

Such questions become more pointed when it is noted that most brokerage houses are owned wholly or partly by trading or merchant banks, and the top 10 traders are all directly tied to major financial institutions. In a recent article, moreover, two executives of major brokers commented on the extent of trading done by brokerage houses for their own account — so-called principal trading. One broker estimated principal trades might account for 60 per cent of the trading done on the ASX, another suggested 30 per cent. Presumably their estimates are based on well-informed experience.[1]

In addition to the concentration in trading, listed Australian corporations appear to have a high degree of ownership concentration. The ASX has published data on the percentage of equity held by the top 20 shareholders in 1989.[2] The reports cover 330 companies and show few companies in which 20 representatives sitting around a table could not vote a majority of the shares. In 94 per cent of the companies examined, 20 shareholders controlled more than 50 per cent of the shares. As Table 1 shows, this ownership pattern is not focused only on a bare majority. The concentration of ownership in the top 25 companies is slightly less accentuated than in the broader group. This is to be expected, for in smaller companies it is common for the founders or their families to maintain significant ownership. Even so, the extent of concentration in the top 25 is rather surprising, a result, no doubt, of the intimate structure of the ASX market. To sum up, a significant portion of the ASX business revolves around the trading in the stocks of 25 companies through 10 brokerage houses, nine of which have links with the major financial institutions and which are in some, and perhaps large, measure trading for themselves as well as clients, the most significant of which are other major financial institutions.

Table 1: Ownership by Top 20 shareholders

Ownership more than	Proportion of companies in which top 20 control more than indicated percentage of company	
	330 companies	Top 25 companies
90%	21%	4%
80%	52%	20%
70%	75%	32%
60%	88%	64%
50%	94%	92%
40%	97%	96%

In effect, the ASX is not a single market. It is at least two and perhaps several different markets. One market, which I will call *Market A*, involves the stocks of between 25 and 50 companies traded almost exclusively by and between large financial institutions. The other market, which I will call *Market B*, consists of about 1,250 companies for which the secondary trading is more occasional than regular. Certainly, the clarity of this distinction is more pronounced in the down-market that followed the overheated 1980s, but most observers would not expect Market A to expand much beyond 100 companies even in the best of times.

Market A

Market A sustains the revenues of ASX, but also offers some worrisome concerns. Some part of Market A is already operating off-market and overseas. The ASX estimated that in the 1989/90 year, 40 per cent of trading in Australian securities occurred overseas. More recent estimates show overseas trading in the region of 20-25 per cent.[3] Efforts by the ASX or the government regulator, the Australian Securities Commission (ASC), to tighten oversight of Market A operations could further exacerbate the ASX's financial woes.

Market A has some special characteristics that need understanding. In dollar terms, the dominant participants in Market A are local institutions, ASX brokers and overseas institutions. Local institutions manage funds often for a wide range of clients; life offices manage their own pooled funds, and for them liquidity of large blocks of shares is crucial.

If a stock looks like a good buy, the institutions are impelled to buy enough for all of their clients or the pooled portfolios of life offices. While some invest for the long term, they cannot afford the risk of riding through a sharp downturn in the market. Others work more short-term strategies which consider interest-rate changes, overseas market behaviour or other timing factors and which create even higher demands for liquidity. Both approaches tend to focus attention on high-capitalisation stocks whose markets can regularly offer significant blocks.

Another constraint on the institutions is the cost of research and analysis. Although the public disclosure required by the Corporations Law and the ASX listing rules probably forms a low-cost method of placing relevant information in the market, institutional investors generally regard this source as too intermittent and too historical for their needs.

They rely more on information relating to future plans which they gain from close observations of company operations and contacts with company officers. Some institutions employ their own analysts; others look to their brokers' analysts, and analysts also watch fairly carefully what their fellow analysts are doing and advising.

However, consistent intensive research does not go much beyond the top 50 companies: the feeling is that the costs of mining for the small gems are difficult to recover, either in profits for the institutional portfolio or brokerage fees. A boom market may extend liquidity somewhat and increase trading in the next 50 stocks or so, and may attract some research into those areas. But when the market contracts, both interest and liquidity disappear.

Principal trading by brokers, which is apparently fairly extensive, is a matter of concern to institutional investors. A recent study found such trading more complementary to, than competitive with, client trading.[4] In general, it appears that brokers are effectively inventorying shares to assist large clients in making trades; they function more as market-makers than as profiteers, and the study indicates that brokers may lose a little on trading but make it up on brokerage fees from large clients who need this facility. The capital connections between brokers and banks have made these practices possible.

Overseas institutions are less interested in particular stocks than in buying into a representative piece of the Australian market. They essentially read movements in interest rates, exchange rates and other economic indicators and move parts of their portfolios among relatively stable industrial countries. They make the country allocation and rely on local expertise for selection, usually preferring a safe portfolio which tends to focus on leading stocks.

Market B

The shape of the rest of market, which I call for convenience Market B, is not particularly clear. It consists mainly of low-capitalisation companies with a high concentration of shareholders, often founders and their families or immediate purchasers from them. Although these 1,250 companies represent less than half the market capitalisation, their aggregate worth is not trivial — probably $75 billion or more.

Their public shareholders, although few in number, are still sufficiently numerous to maintain ASX listing. The shareholders tend not to be institutions, and they hold presumably knowing that their capacity to sell out is relatively slim. The lack of liquidity in the bulk of these shares must reduce the capacity of these companies to raise equity capital.

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These difficulties raise wider issues about the availability of capital for developing and expanding small businesses and the importance of growth by these companies for the economy's overall performance and expansion.

The regulatory structure

Because of recent changes, market regulation is much in the news. Does the current regulatory structure recognise this segmented market? If so, how?

The regulatory apparatus comes in several forms. The Corporations Law establishes the framework for selling new securities, turning on the issue of a prospectus based on a due-diligence investigation which aims at disclosure of information relevant to investor decisions.[5] But large investors (institutions and others placing $500,000 or more) can be sold to without a prospectus, and listed securities can be sold to anyone without a prospectus, so long as the existing ASX listing rules have been complied with and a prospectus was filed at the time of original sale.

Some uncertainty surrounds the law concerning the resale into the secondary market of prospectus-exempt securities originally sold to large investors. In general, the prospectus rules have little effect on secondary traders in Market A securities, except possibly when a Market A company issues rights to listed securities. They affect Market B securities that are new and newly listed, and may raise the costs of issuance for Market B companies.

Another set of market regulations establishes restrictions on market manipulation, short-selling and insider trading.

The market manipulation rules are aimed at behaviour that gives off false information about the extent of trading, prices, the size of the market in a particular security or the company whose securities are traded.[6] The ASX operates a surveillance system to identify such behaviour, and in general it is more likely to turn up suspicious activity in Market B than Market A — no great surprise, given the general illiquidity of Market B.

The general absence of suspicious behaviour in Market A may be attributable to:

- the higher standards of most of its major participants;
- the great familiarity of most of the participants with each other;
- the tendency of so-called "repeat players" to be careful about taking advantage of each other; or
- the depth of the market in these stocks.

That is, the market, not the rules, provides the deterrence. It is also the case that a reasonable proportion of Market A securities trade off-market, either overseas or in other off-market transactions. Although these transactions are reported, they are clearly beyond direct ASX and ASC control.

The short-selling provisions do imply recognition of the two different markets.[7] Simplifying somewhat, the Corporations Law requires that short sales must be on the up-tick. But under ASX rules, short sales may be made at the last sale price, whether up or down, for equity shares in 60 to 70 companies with sufficient liquidity.

In the former case, the Corporations Law requires that the short sale must be reported to the buyer; in the latter case, the report goes to the buyer and to the exchange, so that Market A participants can monitor short-selling in these shares.

In their present form the insider trading rules probably have little impact on Market A.[8]

The rules are tied fairly explicitly to trading by persons closely connected with the company about which they have inside information which will materially affect the price of its securities. Market A generally offers fewer opportunities to such insiders because of the sophistication of its participants and research efforts of the analysts.

Market B, because of its essential liquidity, does offer opportunities if the insider trading is followed by a release of information that stimulates a flurry of no doubt short-lived trading.

The new legislation changing the insider trading rules could alter the situation.[9] It defines an insider as anyone possessing material information not generally available to the investing public.

Since a fair amount of Market A trading turns on the discovery of facts and piecing together of information not yet widely disclosed, the new definition would appear to cover a significant segment of Market A activity.

Most conceptions of an efficient market contain leeway for superior analysis to cover its costs by trading ahead of the rest of the market, and many argue that such allowances are essential in order for the market to operate with an optimal level of information. This legislation could change Market A substantially, and not necessarily for the better.

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By far the most significant controls for listed securities, in both Market A and Market B, lie in the ASX listing rules.[10]

They are quite extensive, but revolve generally around size, internal structure and disclosure.

The size rules ensure a minimum level of capital, assets and profits, and an ample spread of shares among different shareholders. The internal structure rules supplement the Corporations Law requirements on voting and frequency of director elections. Disclosure, however, is the key and is widely claimed to be the lifeblood of a liquid and efficient market.

ASX requirements include semi-annual financial reports, identification of material interests in other companies, dealings with directors and holdings of large shareholders, and prompt release of information on major transactions, dividends, exposure to another company's insolvency and the catch-all "information to avoid a false market".

In June 1991, the ASX announced proposals to change and in some ways tighten listing rules. The key changes include widening the required shareholder spread from 300 to 500 for new listings; increasing the initial share price to 50c; making it easier for foreign companies listed on recognised overseas exchanges to gain ASX listing; requiring more information in half-yearly and annual reports, including cashflow statements, separate industry and geographic segment reporting, and details on a number of financial statement items; bringing the reporting requirements for related party transactions in line with international standards; and, under the definition of associated enterprises, forcing disclosure of cross-holdings within corporate groups.

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These proposals run in several directions: disclosure of more specific information; curbing some recent hidden financial manipulations that led to disastrous market consequences in a few now well publicised instances; and harmonising regulations where possible with internationally accepted requirements. The ASX, however, backed away from its earlier idea of requiring quarterly reports, which is the US standard. The proposals would also delete some rules that regulate internal corporate matters, such as employee incentive schemes.

The ASX conceives its role to be creating a better-informed market, not regulating corporate behaviour. In that spirit, the proposed new rules would widen the catch-all provision to require immediate disclosure of price-relevant information, whether it emanates from the listed company or from one of its associated entities.

The ASX market surveillance, in addition to watching for manipulative activity, monitors trading levels and price changes that may signal the existence of undisclosed information. This surveillance is easier for Market B than Market A, but overall it provides some impetus for continuous disclosure.

Although the required information is useful to the market when it is accurate and complete, it is probably insufficient. Market A, and any quite liquid market, does not operate solely on the basis of this information. And financial information quickly goes stale.

Changes in management, methods of operation, supplier contracts, distribution and marketing systems, financial structure, current and projected investment and cost-control plans and many other factors are more relevant to a current assessment of a company's prospects and hence the value of its shares than the largely historical information disclosed because of the listing rules.

And, as has become clearer with the retrospective view of the 1980s and early 1990s, the current listing rules did not prevent the hiding of significant changes in plans, unsound enterprises and some rather shady practices, nor did the work of professional analysts always ferret them out. The proposed rules are in part a reaction to these inadequacies.

The existing rules do provide a base of information useful to Market A participants. Among the proposed rules, the disclosure of more detailed information on industry and geographical segments of the large multi-business group will be welcomed in Market A.

But analysts will still look for, and advise and act on, information about future prospects rather than past happenings. It is doubtful that the proposed changes will more than marginally improve the quality of information on which Market A trades.

Market B is another story. To some extent the relative illiquidity of Market B is caused by inadequate information. The current rules have not encouraged liquidity — and the proposed rules probably will not, either.

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More details on related-party transactions and on the specifics of revenues, costs and asset values could add some negative information in the market and reduce speculative activity and liquidity.

At the same time, the marginal increase in overall information will not be sufficient to encourage more analysis and investment in Market B companies. The information elicited by the existing or proposed rules will have little bearing on assessment of future product markets, management capability, cost-competitiveness and other factors that potential Market B investors would need.

The ASX and ASC should be thinking about how to keep Market A operating with cost-efficient disclosure systems that suit its large investor participants. The current and proposed rules probably meet that test. As to Market B, disclosure of more historical information may add unnecessary costs to Market B companies and is not likely to improve liquidity. Liquidity among Market B companies is one key to enlarging investment in small companies with potential for expansion.

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In its June announcement the ASX indicated a plan, with details to emerge later, to merge the main board and second board and then differentiate within this one official list between companies that meet international standards and those that do not.

That is a hopeful sign that some clear thinking may be coming.

NOTES

1. See S. Kaye, "Is Your Broker at Risk?", *Stock Exchange Journal*, October 1990, pp 6-7. For a detailed study of ASX principal trading in mid-1980s, see M.J. Aitken, "The Impact of Deregulation on the Australian Securities Industry", (University of New South Wales PhD dissertation, 1990).
2. ASX, The Stock Exchange Financial and Profitability Study, 1990.
3. B. Dunstan, *The Australian Financial Review*, May 22, 1991, p. 17.
4. See M.J. Aitken, note 1, above.
5. Corporations Law, sections 1005-1011, 1017-1034.
6. Corporations Law, sections 995-1001,1014.
7. Corporations Law, sections 846-847, ASX Business Rules, Rule 2.18 and Appendix 6.6.
8. Corporations Law, sections 1002, 1013.
9. Corporations (Legislation) Amendment Act 1991, Schedule 4.
10. ASX Main Board Listing Rules. See particularly Section 3: Continuing Listing Rules.