



NBA
AT 10/17
CEN

DEPARTMENT OF TRADE AND INDUSTRY

1-19 VICTORIA STREET

LONDON SW1H 0ET

Telephone (Direct dialling) 01-215 5422

GTN 215

(Switchboard) 215 7877

JF6899
PS / Secretary of State for Trade and Industry

10 July 1984

Covering RESTRICTED

David Peretz Esq
Private Secretary to the
Chancellor of the Exchequer
HM Treasury
LONDON
SW1P 3AG

Dear David,

FINANCIAL SERVICES

My Secretary of State wrote to the Chancellor yesterday about the line he proposes to take in next Monday's debate on the financial services. The other subject to be discussed at the Chancellor's meeting on 11 July with Mr Tebbit and the Governor of the Bank of England is the proposed Stock Exchange reforms. I attach a background paper by officials for this meeting. *will request if req'd*

2 My Secretary of State discussed the reforms with Sir Nicholas Goodison last night. He shares the aims set out in paragraph 5 of the paper. Although he sees the Stock Exchange as the market place, he is looking at the future relationship between the Stock Exchange and the over the counter (OTC) market. He is aware of my Secretary of State's concern to encourage competition and the relevance to this of the Stock Exchange's decisions on membership fees and charges. On the need for disclosure there was some difference of view between Sir Nicholas Goodison and my Secretary of State. We accept that there is some trade-off between full disclosure of price and volume of transactions as they are carried out, which Mr Tebbit favours, and the willingness of market-makers to maintain liquidity in the market: it was most important therefore to strike the right practical balance on this question. My Secretary of State noted Sir Nicholas' scepticism about the need for and value of "tiered markets". Finally, there was full agreement on the need for an audit trail.

/3 These ..



3 These points are all covered in the background paper by officials. In particular the conclusions at paragraph 22 could with advantage be confirmed informally to Stock Exchange officials if they are agreed at the meeting on 11 July.

4 I am copying this letter and enclosure to Andrew Turnbull and John Redwood at No 10, and to David Bartlett at the Bank of England.

Yours ever,

Ruth

RUTH THOMPSON
Private Secretary

Encl



RESTRICTED

STOCK EXCHANGE REFORMS

Background

1 A year ago the then Secretary of State reached an agreement with Sir Nicholas Goodison whereby, in return for the Government stopping the proceedings then pending before the Restrictive Trade Practices Court, The Stock Exchange undertook the following:

- (i) action to dismantle by stages minimum scales of stock-broking commissions completing this by 31 December 1986;
- (ii) continuation of rules prescribing the separation of capacity of brokers and jobbers;
- (iii) permission for non Stock Exchange members to become non executive directors of corporate member firms;
- (iv) introduction of lay members to the Council of The Stock Exchange;
- (v) establishment of a new independent membership appeals committee;
- (vi) introduction of lay members onto the disciplinary committee.

Arrangements were made for the Department and for the Bank of England to monitor the implementation of these measures and the evaluation and development of The Stock Exchange as an efficient, competitive and suitably regulated central market which affords proper protection to investors. This we have been doing.

2 Towards the end of last year, The Stock Exchange introduced the rule changes implementing (iii) to (vi) above and in March of this year the exemptions legislation we promised was duly enacted. In the following months, the Council of The Stock Exchange (with its 5 new lay members) has been considering points (i) and (ii). In April 1984 it took the first step on (i) by abolition of minimum commissions for overseas securities.

3 It also published a Discussion Paper in April, on which there have been over 300 responses, mainly from its own members, and it hopes to reach agreement later this month on a new dealing system, the abolition of commission scales and new membership rules. The outcome will revolutionise the securities industry in Britain.



RESTRICTED

4 This paper outlines the changes proposed. Whilst the Government should not seem to be exerting extra-statutory pressure, Ministers need to be able to satisfy themselves and Parliament that the reforms of The Stock Exchange meet the terms on which legislation was introduced as set out above. Of the many points in the Discussion Paper the following paragraphs comment on the essential ones.

5 However, the Discussion Paper omitted one major point, namely The Stock Exchange had no clear marketing objective either nationally in its relationship with the OTC market or internationally in its position vis-a-vis New York, Tokyo and Europe. Following discussions The Stock Exchange are now considering this in detail. Our main policy objectives are a securities market able to provide services to UK industry and commerce, private investors and the Government in the most efficient and cheapest way and which is internationally competitive; and secondly an acceptable system of investor protection.

City Developments

6 Reform was long overdue to strengthen the central market in securities in the British Isles in the face of increasing international competition. Dealing costs (tax and commissions) in the UK are higher than in most major financial centres even after allowance has been made for the cut in Stamp Duty in the Budget. It is now generally recognised that dealers in securities need to be well capitalised in order to take the necessary risks in market making. In the past The Stock Exchange rules on corporate membership have made it more difficult for jobbers and brokers to obtain the necessary capital.

7 Response to these competitive pressures was delayed by the RTP case. The agreement last July removed this blockage and by publicly committing The Stock Exchange to reform released and stimulated forces for change. The current regroupings involving jobbers, brokers, banks and other financial institutions are a direct consequence.

The Reforms Under Discussion

8 Since July 1983 The Stock Exchange programme has changed. The intention had been to dismantle commission scales over a period. The plan now is that a new dealing system will need to be introduced along with freely negotiated commissions in one "Big Bang". A point at issue is the deadline. The Government's deadline is 31 December 1986; Sir Nicholas Goodison has spoken of autumn 1985 or late 1985. There are grounds for us to be concerned about this timetable. The original justification for this of



RESTRICTED

abolition of commission by stages is no longer relevant. But the big bang cannot take place until the new market making system is agreed and implemented with all the participants trained to use it. This is estimated to take up to 18 months. We will have to accept a move from late 1985 into 1986, but there should be continued pressure on The Stock Exchange to meet the 31 December 1986 deadline.

9 The original agreement specified continuation of single capacity. It is widely accepted that single capacity in its present form cannot survive the advent of negotiated commissions. Thus a different form of investor protection is needed. We will need to be satisfied that this is an integral part of any new dealing system.

10 The Stock Exchange has also recognised the need to widen its membership if it is to continue as a competitive market in securities. The Council envisages that the rule limiting to 29.9% outside holdings in a member firm should be removed at the same time as the new dealing system is introduced, or even before if the new dealing and market-making teams are to be fully competent with the new technology on Day One. The main issue on membership for Government is whether the rules that ensure that corporate and individual members of The Stock Exchange are "fit and proper" do not inhibit competition from new entrants. There is a particular point on Japanese firms which is considered in paragraph 15 below.

Dealing Systems

11 Many options have been examined by The Stock Exchange but the current options are:

- (i) a dealing system modelled on the New York Stock Exchange (NYSE), with brokers doing business in front of appointed "specialists" on the floor of the Exchange;
- (ii) a competing market-maker system on the lines of the American over-the-counter market (NASDAQ) using a proven computer information system to publish quotations on a monitor screen (the "Quotation Dissemination System" or QDS) with dealings taking place off-the-floor by telephone. This was the basis of the preferred option 4 system in the Discussion Paper;
- (iii) a totally computer-managed dealing system (called "STARS") into which all brokers would put buy and sell orders, with amounts and price, for the computer program to match.



RESTRICTED

(i) **The "Specialist" system:**

12 Stock-broking firms who have not yet found a source of outside capital and wish to continue their basic brokerage function (eg Cazenove, J Capel, Savory Milln, Phillips & Drew) have supported the NYSE system based on specialists. This has, however, the disadvantage of all floor-based markets that it does not operate round the clock and requires cumbersome regulation to prevent the possibility of manipulation by the specialists. Much business is already done by telephone outside floor hours;

(ii) **The "competing market-maker" system:**

13 This is favoured by the leading jobbers and brokers, particularly those who now have the capability to compete internationally. Competition between risk-taking market makers for business, giving investors the best possible market in which to buy or sell stocks, would be coupled with the reliability and efficiency of a proven computerised information system. It would be a system capable of dealing outside normal trading floor hours. The capital commitment of the market-makers means a more liquid market than other options and investor protection can be assured by electronic price surveillance checking quotations against reported trades. The "audit trail" facility would allow policing of a "best execution" rule and of unusual price movements which might indicate insider trading. The "best execution" rule which requires the business to be done in the most advantageous way for the client meets the requirements of investor protection. This is the option being promoted by Sir Nicholas Goodison.

(iii) **STARS:**

14 STARS ("Stock Trading using Aggregated Resources dealing System") is increasingly favoured by the smaller stock-broking firms. In particular it is supported by the three representatives who recently won places on the Council. The attraction to them is that all firms are treated equally and separation of capacity is built into the system. (Market makers can position themselves on either side of the market but their quotes are only part of the computerised pool.) However it may not prove attractive to the majority - it removes the profit potential from dual capacity and undermines the "relationship" element of the business. A further major snag on timing is that this computer system is still in the development stage and could not simply be achieved by enhancing TALISMAN (the present semi-computerised settlement system): like Star Wars, STARS is for the future and could not be a reality by December 1986. It may be that such a system could provide a basis



RESTRICTED

for trading in smaller stocks and development may be continued with that in mind.

15 None of these dealing systems have obtained unanimous approval so compromises have been suggested. A "tiered-market" is one such compromise. The difficulty is that tiering means different things to different people. Some proposals would cause us considerable concern; others less so. In the first category would be a system whereby internationally traded securities would be shown on the computer-based QDS and the less frequently traded securities would continue to be traded by jobbers and brokers on the old Stock Exchange floor. The dangers are that this would set up an arbitrary distinction between quoted companies to the detriment of smaller growing companies. Technologically it would need two market support systems with all the added costs, complications and potential delay. The jobbers and brokers dealing on the bottom tier would be left with the least profitable business (following the advent of negotiated commissions) and there could be pressure for retention of restrictions eg the retention of stamp duty for the jobbers.

16 A method of "tiering" the market which might avoid the worst pit-falls would be to let orders for less-frequently traded stock be matched on the floor of the Exchange by single-capacity firms whilst the bulk of trading took place off the floor on the telephone. This recognises the difficulty in forcing market-makers to provide a fully liquid market at all times in all securities. Nonetheless, The Stock Exchange's ability to handle transactions of widely different shapes and sizes within the same system is one of its main strengths. It is something which is worth retaining if at all possible. Any compromise on "tiering" will need to be strongly justified.

17 The advent of dual capacity for the market-makers and broker-dealers who replace the single-capacity jobbers and brokers needs to be coupled with the introduction of effective means of investor protection. Immediate publication of all prices and quantities traded has been shown in the USA to provide this. Moreover American experience shows narrower dealer spreads, increased volume of trading and improved members' margins. The Stock Exchange members may decide to adopt a "last trade" tape themselves. If not, this issue (unlike other more technical aspects of the debate) does require Government to make it known that such a tape is necessary.

Membership

18 It is the prospect of the end of single capacity which has been the main stimulus to regroupings between firms. A



RESTRICTED

revision of Stock Exchange membership rules to allow 100% outside ownership is to be welcomed for the additional capital it will bring to the UK securities market.

19 The proposal in the Discussion Paper for limiting the number of Stock Exchange members and creating "seats" is however of concern because of its potential to restrict membership.

20 The Stock Exchange is considering including an element of international reciprocity in the vetting of foreign applications for membership. This would apply particularly to Japanese securities firms given the difficulty for British firms in establishing in Japan branch offices dealing in securities and obtaining membership of the Tokyo Stock Exchange.

The Gilt Market

21 This is primarily a matter for the Bank of England and the Treasury. But private investors are involved. Their needs for information and investor protection should be recognised in a way consistent with that developed for the equity market.

Conclusion

22 A number of important issues will be settled during this month. Of those of interest to Ministers it is recommended that officials should make known to the The Stock Exchange in the informal context of The Stock Exchange Monitoring Group the following points:

- (i) investor protection would be best met by disclosure. There are however degrees of disclosure and we would support:
 - (a) a best-execution rule;
 - (b) the existence of an "audit trail";
 - (c) immediate publication (either on screen or tape) of the price and volume of transactions as they are carried out;
- (ii) a tiered market could create more problems than it solves; we would regard it as acceptable only if it is totally unavoidable;
- (iii) fees and charges for membership are acceptable only if they do not constitute a barrier to new entrants;



RESTRICTED

- (iv) the Government would not object to an element of international reciprocity in membership rules.

Department of Trade and Industry

9 July 1984

Stock Exch. Econ Pol. Nov 83.



(14) The Government would not wish to be viewed as
operational, particularly in monetary policy.

Department of Trade and Industry

12 July 1983

