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From: D R H BOARD
Date: 15 October 1984

NOTE OF A MEETING HELD AT 9.30 AM, WEDNESDAY 10 OCTOBER 1984,
IN SIR PETER MIDDLETON'S ROOM, HM TREASURY

Present:

- Sir Peter Middleton (HM Treasury)
- Mr Cassell
- Mr Lankester
- Mrs Lomax
- Mr S Wood

- Mr Beighton (Inland Revenue)

- Deputy Governor (Bank of England)
- Mr George
- Mr Walker
- Mr Allen

FUTURE STRUCTURE OF THE GILTS MARKET

The meeting had before it the note on a last-trade tape and the draft papers on the gilts market attached to the letter of 25 September from Mr George to Mr Cassell.

A tape

2. Sir Peter Middleton said that the fact that a tape was proposed for the equities market, but was not proposed by the Bank for the gilts market, would raise questions in Ministers' minds. There was a question of substance: did the differences between the gilts and equities markets genuinely justify such a difference in their future arrangements? Presentationally, the difficulty was that both markets operated under the Stock Exchange umbrella and the changes in both would be seen as part of a single process of Stock Exchange reform. From this viewpoint one might expect common arrangements for both markets.

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3. The Deputy Governor said that the substantive objective of a new gilts market structure which allowed the market to function smoothly was a fundamental consideration. The differences between the two markets justified the different treatments which were proposed.

4. In discussion the Bank drew attention to the following differences between the markets.

(a) The gilts market lived off the profits from position-taking whereas the equities market relied more on the "turn" made on trades. Market-makers in gilts were therefore more vulnerable to exposure of their positions.

(b) In the gilts market the relatively large number of market-makers made continuous trading in all conditions both possible and desirable. There was no need to encourage fair-weather trading. But market-makers in any one stock in the equities market would be scarcer. Overall liquidity would be helped by encouraging trading (even fair-weather trading). The tape was a necessary encouragement so that broker-dealers could join in alongside market-makers. The market-makers had accepted this because of the privileged opportunities they would have to take deals of up to market size.

(c) A much higher level of liquidity was needed in the gilts market than would be desirable in the equities market. There was already some concern about the shortening time horizons of major institutions dealing in equities.

(d) The Government via the Bank had a particular interest in the gilts market because of its funding requirements. A tape would expose the Bank's position as well as that of other market traders. One argument, not universally accepted, was that the

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Bank could achieve better prices even in the long run through the market's ignorance. Whether or not that was so, the Bank suggested that the primary market would be damaged if market-makers thought the secondary market too exposed because of a tape.

5. The Bank said that their judgement against a tape for gilts (at least at this stage) was backed by several strong supporters of a tape for equities, such as the Chief Executive of the New York Stock Exchange.

6. In a discussion of the arrangements which would exist if there was no tape for gilts, the following points were made:

- (a) Full disclosure of all deals to the Stock Exchange was not in question. If a complaint was made the Exchange was in a position to take up the matter with the relevant broker. However in most cases the small investor could be satisfied by comparing his time-stamped contract with the list of representative prices which would be published the next day. This would show for stated times throughout the day representative prices for selected sizes of transaction.
- (b) The small investor also had the protection of choosing a broker who would act in a single "agent" capacity.
- (c) Market-makers would have access to a screen which in information content would be quite close to an instantaneous tape. The screen would show bid and offer prices. It was not to be expected that that information would remain completely private. It was possible that something like a tape might evolve. But large transactions would probably not appear on the screen.
- (d) In any case the exact arrangements for a tape in the equities market were not finally resolved (eg

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definition of the most actively traded stocks).

7. Sir Peter Middleton said that in the light of the discussion he was satisfied that the proposal not to have a gilts tape was justified. But Ministers would take some persuading. Two compromises in particular might be proposed:

- (a) a tape with some minutes' lag. It was agreed that there was little merit in this;
- (b) an instantaneous tape confined to deals below a stated size. The Bank said this would make it difficult to sustain the floor market in small transactions as it would disadvantage (relative to broker-dealers) the market-makers who concentrated in the floor market. However the published list of representative prices was in effect a condensed 24-hour small trade tape. A full 24-hour small trade tape could be considered if there was a demand for it and appropriate practical arrangements could be devised.

8. The Deputy Governor said that the discussion suggested that it would be advantageous not to present the gilts market proposals as a separate entity. Instead the Bank's paper might be redrafted to present the equities and gilts markets together under common headings. This might allow the differences between the proposed arrangements to emerge more effectively from an explanation of the differences between the two markets. It was agreed that this would be a very useful step.

Tax aspects

9. Sir Peter Middleton pointed out that Treasury Ministers were continuing to look at the tax system and radical options were not excluded. This included bondwashing and capital gains tax (CGT). Decisions would not be reached before the Bank published its paper on the gilts market; that paper would therefore have to avoid tying Ministers' hands (implicitly or explicitly). Changes might be announced in the 1985 Budget.

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The Bank noted this. Some conceivable options (such as withdrawing the CGT exemption on gilts) would have major effects on which the Bank would wish to put in views, but those effects might not disturb the proposed structure of the gilts market. However other options would affect the proposed structure and it would be helpful if these could be identified quickly. The Treasury observed that a comprehensive list, or the ruling out of particular options, would not be possible.

10. The meeting then considered 4 tax privileges affecting market-makers. Of these, the discontinuation of 2 (stock-lending not treated for CGT as a disposal and treating market-makers' bull and bear dividends net) was not suggested. Discussions with the Bank were continuing about exemption from section 472 of the Income and Corporation Taxes Act. However there were some differences of view about the Stock Exchange's special ex-dividend arrangements for medium and long gilts.

11. The special ex-dividend rules allowed medium and long-dated gilts to be traded ex-dividend for 3 weeks before the formal ex-dividend date. This reduced the bunching of sales around the ex-dividend date. However it also allowed an investor to buy before the ex-dividend date and sell cum-dividend just over a year later, thereby converting one dividend in two into a capital gain free of CGT. In discussion the following points were made.

- (a) The Treasury questioned the smoothing argument for the special ex-dividend rules, noting that since 1956 they had not applied to short-dated stock. The market could be expected to adjust on its own. The Bank disagreed. The normal adjustment would be for concentrated selling just before the ex-dividend date to push prices down, encouraging the sales to be spread. But in fact prices might well remain hard because of the knowledge that there would be a strong reverse market immediately after the ex-dividend date.

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- (b) If income tax was levied on "accrued dividend" then dividend-selling and the consequent bunching of transactions around the ex-dividend date would probably be eliminated. But the Bank would prefer the market not to have to cope with this element of upheaval at the same time as adjusting to a new market structure. If it were pursued, the Bank suggested the tax liability should be determined by reference to the investor rather than the broker.
- (c) Alternatively CGT exemption could be withdrawn from
- (i) gilts held for over 12 months but bought during the special ex-dividend period, or
 - (ii) gilts held for less than 13 months.

The latter would be a tidy way to cut down on bondwashing if the present structure of CGT was broadly retained.

- (d) Whatever the means employed to attack bondwashing, market turnover would be reduced. The Treasury felt that tax-induced churning was not a sound basis for market development and the loss of that part of brokers' business was not an argument for a tax stand-still.

12. The Bank said it wished to explore reactions in the market to the possible changes discussed. The Treasury agreed to this. Although the special ex-dividend rules were outside the terms of the Bank's paper, the discussions could naturally be presented in the context of change in the gilts market (rather than the Government's consideration of tax reform). Ministers would wish to have all the possible options open to them. The Bank's assessment of their effects would be valuable. Mr Beighton pointed out that the Bank's paper should reflect the fact that tax policy was a matter for the Government rather than the Inland Revenue.

Other points

13. The Treasury noted that paragraph 12 of the Bank's paper was drafted to include the possibility of gilt auctions. This was an important point. The Treasury would discuss auctions further with the Bank. It was not envisaged that in the future gilts would be sold by auctions alone.

14. In a short discussion of the annex on prudential arrangements, the Bank said a flat minimum capitalisation would not deal adequately with the wide variety of market-makers which was anticipated. Instead more detailed regulation, which would require market-makers to supply a wealth of information, was needed. Broker-dealers would be supervised by the Stock Exchange.

Conclusion

15. The Treasury said Ministers needed to reach a view on the question of a tape before the Bank's paper was issued. It was agreed that the Bank would send the draft paper to the DTI and a meeting of the Treasury, DTI and the Bank would be arranged with a view to seeking a decision from Ministers by the end of the month. The Bank would be revising the draft paper along the lines agreed in paragraph 8 (above).

Douglas Board

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Private Secretary

cc Those present
Mr R I G Allen
Mr M Hall