THE EXPANDING UNIVERSE
OR
BIG BANG REVISITED

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A discussion at the Staple Inn Actuarial Society on 17th February 1987.

Chairman: A.J. Frost

With Contributions from Panelists:

P.D. Jones
M.C. Thomas
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It is hoped that the enclosed paper and contributions on the night will lead to a lively Question and Answer Session on any aspect of Big Bang.
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A Discussion Paper presented to the Staple Inn Society
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The title of this paper is derived from a paper presented to the
Bristol Actuarial Society in September, 1985. That paper had three main
themes - performance measurement, high-risk finance and "the Big Bang".
This current note encompasses only the Big Bang. Attached to this
introduction is a copy of the relevant section of my original paper,
edited and updated in April, 1986. The advantage of the present
discussion over my earlier thoughts is that we have the benefit of some
hindsight. My task, as I see it, in these introductory notes is to draw
attention briefly to those areas of my speculation where I was clearly
wrong, and to those areas where events have not surprised me or, indeed,
other investment managers. A panel of experts drawn from different
aspects of the institutional investment scene will assist me on 17th
February in discussing the main issues with members present. These
guests include a 'broker' (presumably now known as a 'conglomerator');
the actuary of a large private pension fund; and a consulting actuary.
Each of us is involved in the delicate web that is now the framework for
institutional fund management in the City - each of us has an interest in
the proper development of fund management in the last few years of this
century.

1. Introduction

In Section 1 of my note, I refer to the fact that changes in the
activities of the Stock Exchange are but one aspect of a very general
movement by the Government to develop financial markets. The
original note for the B.A.S. was written in response to confusion by
actuarial colleagues concerning the distinction between the Big Bang
and the Financial Services Bill (which has now been enacted). The
"debate taking place on the role and effectiveness of the proposed
and existing self-regulatory bodies" has generated some conclusions.
Most readers of this note will be aware of the distinction between
LAUTRO, IMRO and FIMBRA. The most dramatic outcome of this debate,
however, was the merger of the Stock Exchange with the body
representing principally participants in the Eurodollar market. The
new SRO (self-regulatory organisation) is known as the International
Securities Regulatory Organisation (ISRO). This itself was a
striking demonstration of the move towards internationalisation
mentioned in Section 7.
2. **New Groupings**

It would be rash to assume that the regrouping of activities within the City has yet run its course. The number of gilt market-makers reduced to 27 shortly before 27th October, 1986. The number of major players is well over 70, if one includes international dealerships, equity market-makers, gilt-edged market-makers, Stock Exchange money brokers and related activities. Of this number a large proportion are capable of corporate finance work or are bankers, and many offer fund management services. Since writing my first paper a colleague reminded me that a "Big Bang" and an "Expanding Universe" are not mutually exclusive events. I rather suggested they were in my concluding comments. The fact is that following our Big Bang the universe shows every sign of expanding further. Astronomers will have to advise me the causes of universal contraction. Perhaps it relies upon the relative position of the constellations - in particular, Ursa Major!

3. **Conflicts of Interest**

I spent some space in my first paper discussing conflicts of interest. It gives me no satisfaction to note that since October, 1986, there have been some serious but isolated instances of insider trading. It should be some comfort to record how quickly these cases were brought into the open, the extent to which compliance officers have earned their keep, and the continuing interest of Government in ensuring that self-regulation can be made to work.

4. **Changes in Practice**

It is still rather early to conclude how practice has changed since the end of October. The paradox in the gilt market still exists - even with only 27 players. It appears that the role of the inter-dealer brokers (IDB's) has improved liquidity in short-dated gilts. Conversely, except for commonly traded stocks ('runners') liquidity in long-dated stocks appears to have worsened. As an interested party, I declare that institutional gilt departments are having to work harder as a consequence of the division between agency dealing and dealing directly with market-makers. The Government Broker has adopted a more accommodative role in the new environment and a 'new system' of allowing market-makers to bid for stock, fairly and competitively, has been warmly received, but they have yet to experiment with an auction system.
Liquidity in the equity markets seems about the same even for alpha and beta stocks. There have been some instances of the number of market-makers in gamma stocks reducing. As with gilts it is necessary for fund management teams to work a little harder with their broking contacts to get the best from the system. Perhaps this is the inevitable consequence of lower margins for the suppliers of information. The positive aspect of liquidity has been the readiness of some house to transact "programme trading" i.e. buying and selling large baskets of shares in a portfolio at minimal cost to the client.

The private client has, I believe, benefited more than I expected from the changes. If we ignore the unfortunate experiences of those dealing with firms lacking Stock Exchange membership, the consumer is now being offered a bewildering array of services from those flexing their muscles in the High Street for the first time. In Section 4 I did, perhaps, underestimate the power of the man on the Clapham omnibus. In many instances he does not have to catch a 'bus, because he is being offered instant telephone dealing facilities by many of the new conglomerates at a reasonable cost compared with pre-Big Bang. Perhaps I underestimated the broking margins before October - or the willingness of brokers to loss-lead now!

At present, there are few signs of independent fund managers emerging. Is this a sign of conservatism amongst trustees of pension funds, or lack of entrepreneurial flair on the part of U.K. fund managers?

5. Remuneration

Most institutional gilt fund managers now assume a commission rate of zero other than on agency bargains. Institutional equity commission rates lie between .15% and .25% (15 to 25 basis points). To date, I have heard of no instances of gilt research being charged for cash. The economies of these numbers are self-evident and is one reason for doubting that the current system will obtain beyond a major bear market or other major event impacting on the Stock Market.

For the moment, the consumer is in a strong position, vis-a-vis the traders and suppliers of information.
6. **Technology**

The flaws in SEAQ have been publicised extensively. Nevertheless, the scope of the changes wrought and the size of the systems developed still deserve congratulation. One sad aspect of the new high-tech environment is the very small number of people now left on the floor of the Stock Exchange. Occasions such as the first day of dealing in British Gas shares or the last dealing day before Christmas have become pale shadows of their former festivity.

Plans for developing a third-tier market to supersede the unofficial OTC market have been announced by the Stock Exchange, and dealing started on 26 January 1987.

7. **Internationalisation**

None of those working in securities markets in the U.K. can deny that they are privileged to be part of a major development of the service economy which has drawn worldwide attention. Perhaps some of those who started the process of 'deregulation' and liberalisation of financial markets were true visionaries. For most of us the pace has been staggering. The objective for us all should be the preservation of standards in order to protect the hard-earned savings or premiums of the millions of policyholders or pension fund members entrusted to our industry.

Alan Frost
"THE BIG BANG"

A.J. Frost
April 1986
1. **Introduction**

The Stock Exchange is engaged in the transaction of bargains. How appropriate that the cause of the big bang was a deal struck between Mr. Cecil Parkinson and Sir Nicholas Goodison, Chairman of The Stock Exchange. The Office of Fair Trading wished to investigate the practice of The Stock Exchange and in return for not doing so The Stock Exchange agreed, inter alia, to introduce negotiated commissions in place of the minimum fixed scales which had existed for some time. The Stock Exchange has operated within a self-regulatory framework for many years but it forms only part of the City of London. There had been elsewhere a number of financial scandals during the 1970's. The Government wished to open up the City to market forces, domestic and international; to increase competition between institutions; to improve information for investors and their advisers; to provide a high level of self-regulation; and to be capable of enforcement of the rules and give protection to investors. Although The Stock Exchange has been constantly in the limelight the process which the Government started was intended to encompass the many other activities taking place in the general field of financial services many of which had led to those scandals.

In examining its role The Stock Exchange noted that the number of substantial jobbers had reduced to only 5 by 1976. Pressure was arising from the increasing internationalisation of markets and the presence in London of a strong overseas contingent. After further discussion The Stock Exchange also abolished another set of rules - those obliging the separation for the most part of the activities of brokers and jobbers. A deadline of December 1986 was set for the implementation of changes arising from the abolition of the two rules. The phase "de-regulation" is often used in relation to what is happening. This is a little misleading. Although two significant rules are being abolished by The Stock Exchange, a number of new measures are being introduced to protect investors.

As part of the wider regulatory framework a hierarchy of responsibilities has been established at the top of which is the Secretary of State for Trade and Industry. He will delegate his authority to a regulatory body which will have responsibility for most financial services. The Securities and Investments Board will regulate both the securities industry and insurance and certain other savings activities. There are a number of existing self-regulatory bodies, such as The Stock Exchange itself, who will have to be "recognised" by the board. There is still considerable discussion and debate taking place on the role and effectiveness of the proposed and existing self-regulatory bodies.

History sometimes repeats itself and negotiated commissions were introduced in the United States in May 1975. Fund management there has also changed dramatically with the passing of the "Employee Retirement Income Securities Act", known as ERISA, which introduced the possibility of legal action by pension fund members against trustees and fund managers in connection with their management of the investments. The pressure to perform well meant that many institutions negotiated commissions downwards aggressively in order to reduce dealing costs and assist performance. The reaction from the brokerage houses led to some difficulties in the industry. One other development worth noting was a significant new growth of independent fund management houses. In order to examine the position in London more clearly let us examine the new groupings of significance to institutional investors.
2. **New Groupings**

The abolition of single-capacity trading i.e. the separation of brokers acting as agents on behalf of clients, and jobbers dealing with the brokers, has created a new player in the London securities industry - the market-maker. The main activities of the City fall now into the following groups, most of which are familiar:

1. Broking/Investment Advice
2. Principal Trading
3. Fund Management
4. Market Making
5. Corporate Finance
6. Underwriting/Banking

The introduction of dual capacity means that a broker will in future continue to act as an agent but, if he wishes, can also act as a principal by buying and selling stock for his own book. Jobbers are replaced by market-makers, in effect, but will in future have the ability to deal directly with clients as principals. Agency brokers will continue to act for commission at some negotiated rate. Market-makers or brokers acting as principals will usually buy and sell securities net of commission and thus their remuneration will be the net profit or loss incurred as a consequence of trading.

In the gilt market the two types of operator available to institutional investors will be known as market-makers and broker/dealers (agency brokers). There will also be inter-dealer brokers who will have no direct contact with clients and will act to assist liquidity in the market by dealing between market-makers. The market-maker in gilts will be regulated by the Bank of England in view of his importance and role in Government funding and the issue of tap stocks. In return for a number of unique privileges (and controls) he will make continuous markets in agreed areas of the market. Broker/dealers will have no obligation to make markets and will take a position only if they choose to do so. Apart from their traditional agency business they will probably fulfil a role in matching bargains between their clients (known as block trading in the U.S.) and in developing specialised services.

The equity market will also have market-makers and broker/dealers but there is no specialised group of inter-dealer brokers planned although many will act in this capacity and the supervision of the Bank of England is not necessary. At the time of writing the position of market-makers in equities is not entirely clear. In particular, the requirements for continuous market making are not known.

3. **Conflicts of Interest**

The City institutions have always known conflicts of interest. The work of corporate finance departments in merchant banks has always had to be isolated and the phrase "Chinese Wall" is used to describe the process. Access to confidential, price sensitive information is tightly controlled not only from outsiders but also different parts of the merchant bank or stockbroker. Nevertheless, the rapid re-groupings and the formation of financial conglomerates, sometimes including all six of the activities
described earlier, has led to renewed concern about the effectiveness of these controls. This led one national paper to lead an article with the banner headline "Chinese Walls have Chinks". The concern has caused some conglomerates to house staff in different locations in the City in order to avoid potential embarrassment.

The pressure to perform on many of these securities houses will be intense. Indeed, this is what the Government set out to achieve. Each organisation will be attempting to operate profitably and there is justifiable worry that this pressure may lead to unscrupulousness. To understand the pressure, consider the changes in the gilt market. At present there are two principal gilt jobbers and a very small number of others. By contrast, there will be 28 market-makers in gilts at the end of 1986. This market being regulated by the Bank of England will, hopefully, remain free of impropriety but other, less well-known or less well controlled, securities markets may provide a cause celebre or two before the decade ends.

As an example of current and future potential conflicts of interest consider first the broker. He will have to indicate to a client whether he is acting as a broker for the client, as a principal for his own account, as a market-maker, as a broker for some other person, or as a broker for both such client and some other person. Obvious conflicts could arise if a broker has a principal position in securities on which he is giving advice but note that even where a broker offers an "execution only" agency service he may experience conflicts of interest and he is bound already by the fiduciary obligations imposed by Common Law on agents. The Stock Exchange has issued a discussion document listing potential areas of conflict for the agency broker, many of which exist already. A broker dealing with his client as a principal has fairly obvious conflicts of interest. The Stock Exchange has decided to prohibit the simultaneous combination of the agency and principal capacity in domestic securities. What is still under debate is the extent of disclosure a broker/dealer should make about the profit made on a principal transaction with a client. Agency commissions will be required to be printed on contract notes as at present and The Stock Exchange has taken the view that if a broker/dealer acts as a principal he should disclose his terms on a "riskless principal trade" i.e. where as a principal he has fulfilled a client's buy order by buying the stock elsewhere and selling it directly to the client.

A number of conflicts of interest arise in the case where discretionary portfolio management and principal trading are combined in one firm. An even deeper conflict could arise if a corporate finance function were also part of the business where, conceivably, investment managers might come under pressure to support unattractive issues. The concept of "triple capacity", a combination of broking, fund management and market making raises further conflict because the firm's market making interest may conflict with its agency duties to corporate clients, investment advisory clients and to funds under its management. Integrated firms of this nature might seek to exploit their "captive" clients.

Fortunately, The Stock Exchange has been working hard to provide a background of trust. Its extensive rules, guidelines and discussion documents cover disclosure of capacity, disclosure of material interests, disclosure of ownership and control, the question of reciprocation, the treatment of in-house discretionary funds, marketing agreements with third parties, the manner of communication with clients and the public at large, conflicts
relating to remuneration, the practice of "churning" (excessive size or frequency of transactions), the priority of execution of orders, rules concerning the "best execution" of bargains, and a number of other topics related to financial conglomerates in particular.

The Stock Exchange has considered carefully its membership rules, the various codes of dealing and the future operation of the Compensation Fund. Interested readers are referred to the various documents issued by The Stock Exchange but I hope I have conveyed the impression that although there are severe conflicts of interest, many of them new, The Stock Exchange itself has worked assiduously to retain the confidence of the investing public. So too did the Council for the Securities Industry which produced guidelines for insider dealing, personal dealings of fund managers and so on.

4. Changes in Practice

The impact of the changes on the practice of institutional investors is considerable. First, the changes in gilt trading, apart from the obvious impact on issue and control of tap stocks, are likely to lead immediately to a very different approach by institutions. Until recently a great deal of institutional gilt trading was related either to switching activity aimed at minimising the payment of capital gains tax or to the practice of controlling coupon flow by buy and/or selling stock cum or ex dividend. In some cases the two activities were connected. In July 1986 by a strange "coincidence" the rules relating to CGT on gilts are being changed. Also, from February 1986 all gilt stocks traded have been clean of accrued interest. The bread and butter business of many gilt brokers will be reduced dramatically. Even if this were not the case the institutional approach to these deals is almost automatic and the ability to deal directly with market-makers is extremely attractive. The larger institutions will probably turn their gilt manager into a specialised trader dealing with a small number of market-markets. A number of other broker connections will be retained for specialised agency business. At the risk of repeating myself the paradox is that at a time when the number of "primary dealers" in gilts is increasing dramatically the amount of steady business from life companies and pension funds may fall sharply. In the circumstances, it is not surprising that many institutions will expect dealing costs to fall to virtually zero and many will not be prepared to pay for gilt research. The new system for gilts is planned on the lines of the primary bond market in the U.S. It is unclear whether the Bank of England wishes to alter the tap system as the main process of making primary issues. The Authorities appear prepared to be flexible and are thought to have examined the auction system in use in New York. At present the Bank is unwilling to concede the element of surprise inherent in the tap system but they acknowledge that the auction system has much to commend it.

The new system for equities is modelled on the U.S. Over-The-Counter (OTC) market and the consequences are less predictable. The re-groupings within the City have formed a number of financial conglomerates which, typically, include a broking firm, a merchant bank, a fund management organisation and a market making function. Many of these firms have already announced plans to service the retail end of financial services by dealing in the High Street and through the medium of other savings institutions. They and the many smaller broking firms, often in the provinces, will compete for private client business. Whether in the longer run the costs of dealing through these agencies in the High Street will prove cheaper than at present is a moot
point. The proverbial man on the Clapham omnibus will hardly be in a position of strength to negotiate commissions. For institutions the position will be different. First, some institutions will wish to use market-makers if transacting business in large capitalisation stocks because, as in the case of gilts, they will have decided in advance on a course of action and will be looking for the cheapest mechanism of effecting a bargain. What institutions will be most anxious to keep is their valued relationships currently enjoyed with equity brokers in which ideas for investment, analytical research, market gossip (and, occasionally, cricket scores) are constantly discussed and exchanged. For many this relationship built up over many years will be more important than the ability to trade a large line of popular stock infrequently. From the point of view of performance cheap lines of stock are clearly important but so are the suggestions for purchase that will produce sound above average growth in the medium term. There will be a ready market for those agency brokers prepared to find the ideas of tomorrow rather than concentrate on trades in the big capitalisation issues of today.

More generally, those institutions who retain at present external fund managers may well review this policy in the light of the potential conflicts of interest perceived, whether these be real or illusory, within the conglomerates. Perhaps, as in the States, a new breed of independent fund managers will emerge.

5. Remuneration

The whole development began with a desire to remove fixed minimum commissions. At this stage it is still not clear how all different parties will be remunerated. If most gilt business is in future conducted through market-makers, then agency gilt commission levels will in aggregate reduce dramatically. It would seem unlikely that broker research on gilts will be paid for by the larger institutions in future since they will deem payment to be incorporated in the margins of the market-makers. Some clients will continue to pay for research indirectly through agency commission. In a world where fees are becoming increasingly important it is possible that some houses will try to charge for gilt research and expect ready money.

Equity research may need more careful discussion concerning payment and no doubt before next Autumn a number of hard bargains will have been driven. Institutions will probably argue for all services (sales, research and dealings) to be paid for within the new (lower) level of agency commission. Some brokers may request a retainer.

The position of the conglomerates in the equity markets may well prove interesting. Some have already indicated that their fund management arms will be free to solicit research from any source, including the research arm of a rival conglomerate. If a new group of independent fund managers were to spring up would this be accompanied by new independent research houses? If commission levels are driven too low some institutional clients may not be large enough to generate sufficient commission to pay for research. There may be a temptation to cut dealing costs to the bone in order to enhance performance of discretionary funds. In this eventuality fund management houses might be forced to pay fees for research or advice and debit their management accounts or, of course, to increase their fees?
6. **Technology**

For the new Stock Exchange procedures to work efficiently it is necessary for new technology to be introduced. The Stock Exchange has split its new systems into three broad areas - trading support, surveillance and settlement. The settlement system, Talismen, will continue in use but will be replaced gradually over the longer term. The principal information source for brokers, jobbers and clients at present is TOPIC. This is an extensive system based on Viewdata technology and is fed by the EPIC computer system of The Stock Exchange. A new system call SEAQ (Stock Exchange Automated Quotes) will be introduced in time for the big bang which will receive quotations and reports on trades from market-makers which will then be fed to EPIC. SEAQ is planned to cover around 1000 securities including all the leading U.K. equities, the main gilt issues and certain international securities. It is not intended at this stage that SEAQ will support the primary gilts market. Many primary dealers in the gilt market are expected to offer a closed-user screen price service to selected institutional clients. Despite the hopes of some institutions the IDB screens (which all market makers will have) are not likely to be visible outside this charmed circle. Longer term plans are naturally intended to be much wider in their scope. There are, in addition, a larger number of proprietary information systems which are used alongside the official Stock Exchange systems.

Although much of the future dealing will take place with the aid of screens and sophisticated technology some personal presence will still be required on the floor of The Stock Exchange to deal in second-line stocks, options, more esoteric issues and to handle much private client business. These people have already been christened "slaves". If the opinions of certain well-informed people are correct then the House could become a much quieter place.

Plans for a new electronic "over-the-counter" (OTC) market for unlisted stocks are expected from The Stock Exchange shortly. The market would deal in the securities of smaller and more speculative companies than those now traded on The Stock Exchange's existing second-tier Unlisted Securities Market. It would supersede the unofficial OTC market which is operated by a number of small, non-Stock Exchange market making firms and would qualify as a Recognised Investment Exchange and would be a new self-regulatory body.

7. **Internationalisation**

I have already mentioned the larger number of foreign players in the City. For some of them London is a point on the map between New York and Tokyo which serves their objective of transacting business for 24 hours each day. The modelling of the new London gilt and equity markets on U.S. counterparts will assist in maintaining London as a dominant capital market in the future. Already there has been talk of common standards for new issues involving consistent documentation and standard accounting practice, disclosure and so on. Some small European stock markets have in the past been swamped by a relatively small amount of U.S. pension fund money and the consequences of true internationalisation of stock markets cannot be guessed. The recent bid by an Australian brewery, Elders, for Allied-Lyons is but one symptom of the new world in securities. Whether this is what the Government had in mind when it decided not to pursue the O.F.T. investigation is another matter. Did it want a big bang? Or an expanding universe?