FINANCING OF SHAREBROKERS

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Introduction

A stock exchange may be regarded as the fulcrum point of the capitalist system. It constitutes the mechanism whereby the means of production of a society may be owned, not by the state, but by the community at large, and pursuant to which the strong may prosper and the weak may be consumed. It is therefore ironic that within this bastion of the private enterprise system, the means whereby a broker carries on his business, and funds his operations, are subject to a startling degree of regulatory restriction and involvement. At the same time, it must be acknowledged that October, 1987 saw a stock market crash of unprecedented proportions, in which the instance of failure on the part of brokers has, to date at least, been minimal. This, in part, may be testimony to an effective regulatory system.

From a lawyer's point of view, the preparation of a paper on "Financing of Brokers" is initially appealing, but one soon thereafter becomes lost in something of a regulatory morass. For the sake of us all, this afternoon, I will endeavour to delineate the boundaries of the bog, but to tread as lightly as possible across its surface.

On a practical basis, the funding needs of the business of a broker are relatively easy to describe. They may be expected to encompass the following:

(i) the funding of obligations assumed in the buying and selling of stock in his capacity as agent;

(ii) the funding of obligations assumed in the buying and selling of stock in his capacity as principal;

(iii) the funding of obligations assumed pursuant to underwriting and placement arrangements; and

(iv) the provision of extensive resources for investment research, communication and storage of investment data, and the backroom facilities required to handle the processing of stock transfers.

What, however, I must address are the regulatory obligations that are placed upon a broker, that either stipulate the level of financial contribution within the business, or constitute operative constraints upon his funding arrangements. Against this backdrop, I would then like to consider the security that is available to a broker for the purpose of financing, and, finally, I propose to look briefly at what has become the primary source of financial contribution, equity participation by institutional shareholders, and the possible legal pitfalls that may result.

Regulatory Requirements of Brokers for Finance

Outline: The regulations which directly control the requirements of brokers for finance are to be found in the Business Rules of the Australian Stock Exchange and in the conditions of his licence as a dealer under the Securities Industry Code.

Capital Liquidity Requirements - ASX Business Rule 1.1: The Australian Stock Exchange Limited is a company limited by guarantee. That company may hold, or may cause its state subsidiaries to hold, official meetings of its member organisations. The business of such meetings is to make prices, effect sales, and record quotations and sales of securities. In order to participate at such official meetings, one must be a member organisation. The articles of association set forth the requirements for membership, and provide for the making of rules for the order and good government of the member organisations of the Exchange and its affairs, including rules with respect to the conduct of business by the member organisations. A broker, as a member of that company, is accordingly contractually bound to comply with the Business Rules and such compliance is clearly a condition of his continued membership.

Rule 1.1 sets forth the capital liquidity requirements of a broker. A broking partnership not including a corporation must ensure at all times that the Adjusted Liquid Capital in its business is not less than $50,000.00 or 5 percent of the Aggregate Indebtedness, whichever is the greater. A broker which is a member corporation must ensure at all times that the Adjusted Liquid Capital in its business is not less than $250,000.00 or 5 percent of the Aggregate Indebtedness, whichever is the greater.

The importance of these requirements cannot be over-estimated. The obligation to maintain that level of capital liquidity will constitute an active constraint on the growth of the business of a broker in a bull market. It will determine the nature of the security that the broker may offer to the financier. Most importantly, a market crash may result in a breach of that requirement. A broker who is in breach cannot continue to trade, and this in turn will cut off the cash flow that may have been relied upon by the financier in the approval of the finance facilities.

As stated, the requirement is for Adjusted Liquid Capital to exceed the stipulated dollar amount, or 5 percent of Aggregate Indebtedness, whichever is the greater. A full analysis would require a detailed consideration of the definitions of the terms "Adjusted Liquid Capital" and "Aggregate Indebtedness" which in turn would lead to definitions of "Liquid Capital", "Approved Adjustments", "Approved Subordinated Debt" and "Excluded Assets". What follows is instead a more superficial analysis. The Adjusted Liquid Capital of a broker includes his current assets, at the lower of cost or market, from which there are excluded assets which are not readily capable of realisation.

In addition, there may be taken into account an unconditional approved bank guarantee in favour of the Exchange, which is not secured by a charge over the assets of the broker.

The Aggregate Indebtedness of the broker means his total liabilities, but excludes amounts adequately secured against other assets and approved subordinated debt.

The Business Rules contain detailed provisions which prescribe the conditions upon which subordinated debt may be approved. The basic concept, as might be expected, is debt owing by the broker on conditions such that any right of the creditor to receive payment in the case of bankruptcy or liquidation is to be subordinated, to such extent as will ensure payment, or provision for payment, of all claims of all other present and future creditors of the broker, in priority to the claims of all subordinated creditors. The terms of the subordinated loan deed must be approved by the Exchange, and must include certain specified provisions. In particular, these must address arrangements to cover liquid asset requirements upon the maturity date of any loan for a fixed term, and a prohibition on repayment if the Exchange is not satisfied that the broker is capable of continuing to comply with the regulatory obligations following such repayment.

Notwithstanding the somewhat tedious definitions which I have passed over, the concept is relatively clear. The objective is that there be within the business of the broker currently available assets exceeding 5 percent of the indebtedness of the business. At face value, this might not be seen as an unduly harsh ratio, but it must be considered against the operational realities and practices of the industry.

In addition, there must be taken into account the underwriting obligations that may be assumed by a broker. In its simplest terms, an underwriting agreement is an obligation to procure applications for the shortfall, if any, arising upon a stock issuing. There is a saying amongst solicitors that there are old solicitors and bold solicitors, but few old bold solicitors. That saying has equal application to underwriters. An underwriter, like any successful Queensland SP Bookie, will have laid off his commitments to sub-underwriters before signing the

underwriting agreement. In the best of families, however, things can go wrong, and a sudden obligation to take up a substantial portion of an issuing, which comes onto the market at a reduced price, may well have immediate impact upon compliance with the liquidity requirements.

Conditions of Dealer's Licence - Securities Industry Code: The second area of regulatory intervention is the application of the conditions applicable to the holding of a dealer's licence under the Securities Industry Code. Section 43 provides that a person shall not carry on a business of dealing in securities unless he is the holder of a dealer's licence. Section 51 confers on the Corporate Affairs Commission, a discretion to impose conditions and restrictions when granting a dealer's licence or at any time when the licence is in force. The section specifically states that such conditions and restrictions may include those relating to the financial position of the holder of a dealer's licence.

In practice, the Commission does not impose an independent obligation upon brokers, but instead relies upon compliance with the capital liquidity requirements set forth in the ASX Business Rules. Such compliance is incorporated as a condition to the licence.

This must also be read subject to Regulation 18 of the Securities Industry Regulations. A licence is deemed to be granted subject to a further condition that the holder shall immediately notify the Commission in writing of any matter that may adversely affect the financial position of the holder.

Operational Requirements

In any consideration of the funding requirements of a broker's business, it is necessary to have regard to the operational environment in which he operates.

A broker who buys or sells stock on the Exchange, on behalf of a client, does so as agent for an un-named principal. As such, he is liable on the contract formed, either to pay the purchase price or to deliver the scrip. Business Rule 4.33 provides that ten business days shall be allowed for delivery of securities. Where a broker fails to deliver securities in accordance with that Rule, the buying broker may institute the buying-in procedures set forth in Business Rule 4.4. The curious anomaly in the Rules is that it is nowhere stated that there is an obligation upon the buying broker to make payment to the selling broker within ten business days. In an earlier edition of the Business Rules, prior to the incorporation of the Australian Stock Exchange Limited, the Rules did contain such a provision. The document that is currently issued by the Exchange, headed "Memorandum and Articles of Association and Business Rules" does in fact contain a provision which is headed "Ten Day Net Settlement", but the provision is left blank. Notwithstanding, it is commercial practice that where delivery of the securities

is made within the ten business days, the buying broker is held liable in his own right to effect immediate settlement.

His recourse in such circumstances is set forth in Business Rule 3.6.2. In such an event, the broker may re-sell the securities, the subject of the contract, at the client's risk and expense, which expense shall include brokerage and stamp duty. If a loss results, the client is required to account to the broker for that loss. If a profit results, the broker is required to account to the client for the same.

The obligation upon the broker to complete the buying transaction, and his ability to re-sell and recover any consequent loss, are central to the well-being or otherwise of the broker's cash flow. Whilst it is a diversion from the strict topic, it is relevant to consider briefly the question as to whether or not the terms of the Business Rules and the accepted practices and procedures are deemed to be a part of the contract entered into between the broker and the client. In W. Noall & Son v. Wan [1970] VR 683, Menhennitt J. considered this issue, and, in reaching his conclusion that the Exchange Rules and Regulations were a term of every dealing in which the plaintiff had bought or sold shares, relied upon the endorsement on the contract note of the terms "subject to the Rules and Regulations of the Stock Exchange of Melbourne". In that case, the defendant had dealt regularly with the plaintiff, and had received regular notice that the transactions would proceed upon that basis. The judge therefore found that it was unnecessary for him to express any view as to the alternative base upon which the plaintiff put its right, namely common law or custom.

If this were the extent of the authority, a broker would be hard pressed to incorporate the Business Rules into his contract where the client had not previously dealt, or dealt infrequently. The matter would seem clearly to have been put beyond doubt by Street J. (as he then was) in Bonds and Securities (Trading) Pty. Ltd. v. Glomex Mines N.L. [1971] 1 NSW LR 879. He stated as follows:

> "Each party, by employing a broker to buy and sell shares in the Stock Exchange, authorised him to act according to the usages, including any relevant articles and regulations of the Stock Exchange. The course of business in dealings of the Stock Exchange will provide the context in which the contractual relationship between the present parties is to be determined."

There are, accordingly, comprehensive provisions within the Business Rules which require the clients of brokers to perform within stipulated periods, and which confer upon the brokers adequate powers to initiate buying-in procedures or the disposal of securities purchased on behalf of defaulting clients. In theory, these provisions are all very well. In practice, the heady atmosphere generated by a rampant bull market contributes not only to large volumes of transactions in respect of which the

brokers are not in funds, but major delays in the handling and settlement of market transactions. These delays arise both within the broker's own back offices, dealing with the processing of market transactions, and with the registration by the companies themselves of share transfers and the subsequent issue of share scrip. The consequences are major disruptions to cash flow and reputedly spectacular overdrafts by certain major brokers.

The cycle within the broking industry is seen time and time again. As the volume of transactions increases to what appears to be an inevitable breakdown of the system, the problems are alleviated by a major market crash. The concern from the financier's point of view is that at the time the broker's need for financial assistance is greatest, the internal controls and procedures are at their least. On the other hand, those brokers who have seen it all before are reluctant to gear up for a volume of trading which cannot, in the long run, be sustained.

The further area in respect of which brokers have sought financial accommodation is, of course, with respect to their own dealings. Participation by brokers as principals in the market is recognised within the Business Rules of the Exchange. Business Rule 3.1 sets out the requirements for disclosure where the broker is acting as principal. Pursuant to rule 5.6, a client order is to take precedence over the order of the broker. It is, however, salutory to reflect upon the following comments by Street J. in the Glomex Mines N.L. Case:

> "There remains yet another aspect of concern in the circumstances disclosed in the present case. I had occasion in Hewson v. Sydney Stock Exchange Limited [1968] 2 NSW LR 224 at 231, to draw attention to the vice inherent in members of the Stock Exchange trading in shares on their own account. Their duty is to act for their clients, not to enter the market themselves and trade in competition with them. The morally unhealthy practice of sharebrokers being also share traders is seen to have been blatantly carried on in the present facts, ... Whichever way one seeks to rationalise or justify this course of conduct ...., one is confronted with an unacceptable situation of conflict of interest."

Regulatory Constraints

Outline: An analysis of the flexibility available to a broker in organising financing must also take into account some additional regulatory constraints. These are again to be found in the provisions of the Securities Industry Code and the ASX Business Rules.

Maintenance of Trust Account: Section 73 of the Securities Industry Code requires the maintenance by a dealer of a trust account, and the payment into such an account of all moneys held

by him in trust for a client, not later than the next business day following the day on which they are received. This provision is reflected in similar terms in Business Rule 1.2.2.

The presence of this provision may well reflect the further comments of Street J. the Glomex Case to which I have referred earlier. At that time, the relevant regulatory provisions required the payment of trust moneys into a trust account not later than the third banking day after such moneys were received. Evidence was given to the effect that moneys would customarily be paid into the general account of the broker, either to be paid out or, presumably, to be paid into the trust account within the stipulated period. In the event of a failure of the broker, the trust funds would clearly have been mixed with the broker's own funds and the trust would be defeated. Street J. expressed the hope that the Stock Exchange authorities would direct some attention to those inadequacies, and it would appear that the appropriate amendments have been made.

In a continuation of the protective mechanism, s.74 of the Securities Industry Code specifies the purposes for which moneys may be withdrawn by the dealer from the trust account, and this also is reflected in Business Rule 1.2.2(4).

Loans From Clients: The second constraint is concerned with the procedures required for the making of loans by clients to brokers. Reference should be made to the decision of the High Court in 1986 in Daly v. The Sydney Stock Exchange Limited (1986) 4 ACLC 283. The case arose out of the collapse of Patrick Partners in 1975, and involved a claim against the fidelity fund of the Exchange with respect to moneys lent to and not repaid by the firm. A client of the firm, who had wished to invest moneys in shares, had been advised by an employee that the time was not ripe, and that he should instead lend the moneys to the firm. The firm was ostensibly large and prosperous, but in fact was in a precarious financial situation. The point in issue was that, in order to come within the operation of the fidelity fund, the money must have been entrusted to, or received by, the firm for and on behalf of the client, or by reason that the firm was trustee of the money. The Court concluded that the firm had received the moneys as a borrower, and not as a trustee, and that no constructive trust could be derived from the circumstances. The client was therefore precluded from claiming.

The Business Rules adopted by the Australian Stock Exchange and s.67 of the Securities Industry Code now set forth a more detailed regulatory procedure. Where a client lends money to a broker, the broker shall deposit the moneys in a trust account, furnish to the client a document, in prescribed form, setting out the terms and conditions on which the loan is made and accepted, including the purpose for which and the manner in which the moneys are to be used by the broker, retain the moneys in the account until the client has given to him a written statement acknowledging that the client had received the document, and use

the moneys only for that purpose. The prescribed form is set forth in a Schedule to the Securities Industry Regulations and a form of letter is also contained in Appendix 6.1 to the Business Rules. The forms are not identical, and one might well argue that the Appendix to the Business Rules in fact does not go far enough, particularly with respect to disclosure of the purposes for which the moneys are to be used, to completely conform to the requirements set forth in the Securities Industry Code.

It is also of interest to note that the Appendix to the Business Rules requires the statement that the loan is not protected by the fidelity fund of the Exchange. This presumably gives effect to the decision in Daly's Case, but one might argue that there is now a distinction between the situation that pertained in Daly's Case and the present requirement. The funds are now received by the broker as a trustee, and thereafter applied from the trust account to the use of the broker. It would seem to me at least arguable that, as the moneys had initially been received by the firm as trustee, the requirement for a claim against the fidelity fund may be met.

Holding of Client Security Documents: Security certificates delivered to a broker in the course of his acting on behalf of a client are no doubt trust property which the broker, as a fiduciary, is bound to hold at the direction of the client. This obligation is given statutory effect in s.72 of the Securities Industry Code. The section does, however, recognise the circumstances under which a broker may deposit, as security for a loan or advance made to the broker, documents that are the property of a client and for which the broker is accountable. Those circumstances arise where an amount is owed to the broker by the client in connection with a transaction entered into on behalf of the client. The important requirement is that the amount of the loan not exceed the amount owed to the broker by the client.

Broker's Lien

Reference has been made to the provisions of the rule which enables a broker to re-sell securities for which the client has failed to make payment. A broker may well hold other securities on behalf of the client, and it is settled that the broker holds a lien over those securities for moneys which may be owing in respect of other transactions: John D. Hope & Co. v. Glendinning (1911) AC 419. The difficulty is that it is restricted to a lien, that is, a passive right to retain the securities, and in the absence of further agreement there is no power of sale.

Analysis of the Security that may be offered by a Broker

In the end result then, what is the security that is available for a financier providing financial accommodation for the business of a broker? In a prosperous business, there is no doubt value in the goodwill and the client list. This value is,

however, subject to the cyclical vagaries of the industry. There is secondly the book debts of the business which, in a buoyant market, will represent the bulk of the cash flow of the broker, and the reason for the necessity for financial accommodation. The broker should be protected against the book debts by the holding of scrip, but in a falling market the value of the scrip will not provide full cover. It is precisely in those circumstances that the recoverability of the debts will be most affected. If the broker engages as a principal, there may well be scrip available as security, and there are finally the personal assets of the broker. Several elements must always be considered:

(a) the value of the goodwill and the continuation of the cash flow generated by the business will depend upon the business being continued, which in turn will depend upon the capital liquidity requirements being maintained;

(b) the granting of financial accommodation, unless it is by way of approved subordinated debt, cannot assist the position with respect to the available capital liquidity, and the taking of security will diminish that liquidity;

(c) the value of the goodwill, the continuation of the cash flow, the recoverability of the book debts, and the value of the broker's own scrip will all be linked to the fortunes of the market.

All in all, it must be acknowledged, from a financier's point of view, that there are inherent problems.

Financing through Equity

The demands imposed by the financial needs of a broking organisation are no doubt one of the factors that has led to the revolution over the past four years in the general ownership structure and pattern of brokers. The ability to incorporate, together with the introduction of 50 percent ownership by non-members, followed by 100 percent ownership by non-members, has entirely changed the face of the profession. All major Australian Trading Banks own broking organisations. Several major broking firms are publicly listed. Few of the major players do not have major institutional shareholders. One must ask whether, without the presence of the major shareholders with independent resources, the demands of the bull market and the following crash could have been accommodated with as little external sign of stress as has in practice been found possible.

Conflict of Interest

I would therefore like to look briefly at what might be the consequences of full ownership by financial institutions of broking corporations, and to sound a note of warning. The possibility of conflict of interest in this area abounds.

Street J. in the Glomex Mines Case, also expressed his views with respect to the conflict between the roles of underwriter and broker in the following terms:

> "There is already some disquiet associated with a broker stepping outside his role and fulfilling underwriting functions such as are more becoming to a financier or merchant banker. The matter of concern in a broker acting as underwriter is the risk of loss to himself if the underwritten issue is not filled. The presence of this risk involves at least the prospect of tainting any advice he may tender to his clients in connection with the underwritten shares. In the present case the multiplicity of interest affecting [the parties] in this underwriting venture do not need elaboration. It must have been difficult indeed for a client of the firm to have obtained honest and disinterested advice in connection with this floatation."

Consider, however, the addition of the further role of that of banker. A common reason for equity raising is to reduce debt. Can a banker, through its broking arm, legitimately act as underwriter, and procure subscription from its own clients, when the objective is to reduce its own debt exposure? A multiplicity of such factual situations readily come to mind. In Commercial Bank of Australia Limited v. Amadio [1983] 151 CLR 447, the Australian High Court gave effect to the doctrine of unconscionable bargain, with respect to the activities of a bank. In North America, however, there are decisions that represent, from a bank's point of view, far more alarming consequences.

Refer, for example, to the 1986 decision of the Ontario Court of Appeal in Standard Investments Limited v. Canadian Imperial Bank of Commerce [1986] 53 OR 663. In that case, the plaintiffs, who were customers of the defendant Bank, were planning a takeover of a company by way of a share purchase, and they borrowed from the Bank in order to finance their market acquisitions. Indeed, they had told the Bank's President in confidence at an arranged interview everything of their plans, and he in turn assured them of the advice and assistance that the Bank could and would afford them. However, a shareholder of the target, who held voting control, was a director of the Bank and was opposed to the takeover. Three months before the plaintiffs had sat down with the Bank's President, the Bank had decided to enter the market, and by acquiring shares to help prevent any takeover. Thereafter it financed the acquisition of a strategic 25 percent interest by the defending camp and finally sold its own interest to that camp. The plaintiffs were thus left with a minority 32 percent holding, the final defeat of their takeover efforts, and an inevitable subsequent drop in the market value of their shares. It was held that the Bank was, in the circumstances, a fiduciary vis-a-vis the plaintiffs and during the relevant period was in an increasingly blatant conflict of interest and duty position. Damages were awarded against the Bank, necessarily running into the millions of dollars, in order to compensate the plaintiffs for all that they had lost through investing in the shares.

Whilst this is the first Canadian authority holding that a bank was subject to a fiduciary obligation to a customer, there is a significant body of United States authority to this effect. The question that arises in each case is whether the bank has crossed the line from a debtor-creditor relationship to that of fiduciary. If, in any set of circumstances, the loan is to be applied, in whole or in part, against the overdraft of another customer of a bank, or a mortgage security is to provide security for the unsecured debt of another customer, the conflict of interest and duty rule is at the banker's door. These questions readily arise in day to day banking relationships, but their possibility is ever so greater if the banker has assumed the role of an overall provider of full and comprehensive financial services. Can the one financial institution provide financial accommodation to a company, corporate advisory services with respect to its floatation, underwrite the issue of its shares, and thereafter, through its broking arm, recommend to the bank's customers the acquisition of the shares? The thrust of the North American decisions is that when the bank has assumed an obligation to a customer additional to that of the strict debtor-creditor relationship, the relationship of a fiduciary arises. To my way of thinking, the financial institution is wearing too many hats to reconcile his conflicting duties. I am not suggesting that the Standard Investment Case represents the current state of law in Australia, but there is no doubt that our own High Court is of a creative mind, and looks increasingly to North America for its inspiration.

Another developing area of the law that may fall to be considered in these circumstances is the modern law of negligence. Reference should be made to the recent decision of the High Court in Hawkins v. Clayton, and in particular the judgments of Justices Brennan and Gaudron. That case was concerned with the difficult question of economic loss by reason of a failure to disclose or volunteer relevant information, namely, the failure by a firm of solicitors to disclose the existence of a will. Justice Gaudron, for example, addressed the issue as to what indicates the existence of a relationship sufficient to give rise to a duty to exercise care in the giving of information when the damage suffered is economic loss. She expressed this as follows:

> "Thus a relationship of proximity may be constituted by the reasonable expectation of a person (including a reasonable expectation that would arise if he turned his mind to the subject) that the other person will provide relevant information or give reliable information, if that expectation is known or ought reasonably to be known by the person against whom the duty is asserted."

That is a very wide statement of principle, and must be of real concern to all organisations that provide advice which may result in economic loss. I emphasise that the term "reasonable expectation" is adopted by the judge because she considers that it is "a concept which is more readily applicable to omissions

than is the concept of reliance". A financial institution which provides comprehensive services, including broking, may well be running a great risk. Its difficulty is that, within its umbrella organisation, it knows too much, and corporate veils and chinese walls may not save it. Similarly, reliance on client confidentiality is far from convincing where it is used to justify a course of self interest in a situation of conflicting interest.

There are of course the arguments to support the existence of chinese walls and that in itself would warrant another paper. The concept of chinese walls finds recognition in the rules against insider trading in the Securities Industry Code, and, in the provision of the Business Rules, the term itself is defined. Notwithstanding the compelling commercial arguments, it is not a concept that finds great favour in the rarified precincts of the courts. The fundamental approach has been against anything that involves a conflict of duty, and certainly in the Standard Investments Case, the chinese wall argument provided no assistance. In Black v. Shearson Hammell & Co. 72 Cal. Rptr 157 (1968), for example, a stockbroker allowed his agents to encourage clients to purchase shares in a company, on the basis of positive information available about that company, when he, in fact, was in possession of confidential information which indicated that the company's situation was parlous. The stockbroker was held liable for fraud.

The further aspect is that there may well, in the current tight trading conditions, be a trend to integrate the owner with its broking arm more closely, such that the major decisions will inevitably have full involvement of senior management, rendering any argument on the basis of walls difficult to sustain.

Conclusion

I am conscious that this paper raises more problems than it solves. I have dwelt on the regulatory obligations and constraints that prevail with respect to funding a broker's business, and the operational requirements of that funding. I have endeavoured to analyse the substance of the security that might be offered and have concluded that it is less than encouraging from a financier's point of view. I have finally expressed what I believe are serious concerns with respect to the consequences that might flow from the major involvement of financial institutions in the ownership of broking businesses. I can only conclude by saying that, notwithstanding whatever matters I may have raised, most brokers of my acquaintance drive faster cars, live in larger homes, go to more lunches, and generally lead a lifestyle more attractive than any humble lawyer may ever hope to aspire to.