THE PARLIAMENT OF THE COMMONWEALTH OF AUSTRALIA

AUSTRALIAN SECURITIES MARKETS AND THEIR REGULATION

PART I

Report from the Senate Select Committee on Securities and Exchange

Volume 1
Report

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Senator P.D. DURACK, LL.B(Hons), B.C.L., (Western Australia), (Appointed 17 August 1971)

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Senator A.G.E. LAWRIE, (Queensland)

Senator J.A. LITTLE, (Victoria)

Senator J.P. SIM, (Western Australia)

Senator J.M. WHEELDON, B A(Hons), (Western Australia)

Senator the Hon K.S. WRIEDT, (Tasmania)

FORMER MEMBER

Senator the Hon Sir Magnus CORMACK, K.B.E., (Victoria) (Chairman from 21 April 1970 to his election as President of the Senate on 17 August 1971)

TERMS OF REFERENCE

On 19 March 1970 the Senate resolved:

(1) That a Select Committee be appointed to inquire into and report upon the desirability and feasibility of establishing a securities and exchange commission by the Commonwealth either alone or in co-operation with the States and the powers and functions necessary for such a commission to enable it to act speedily and efficiently against manipulation of prices, insider trading and such other improper or injurious practices as the Committee finds have occurred or may occur in relation to shares and other securities of public companies, and to recommend generally in regard to the foregoing such legislative and administrative measures by the Commonwealth as will, having regard to the constitutional division of legislative power in Australia, enable the utmost protection of members of the public and the national interest.

(2) That the Committee consist of Senators to be appointed by a subsequent resolution.

(3) That the Committee have power to send for persons, papers and records, to move from place to place and to meet and transact business notwithstanding any prorogation of the Parliament.

(4) That the Committee have leave to report from time to time its proceedings and the evidence taken and such recommendations as it may deem fit.

(5) That the Senate authorise the publication of all documents which may be laid before the Select Committee and of all evidence which may be given before it except such particular documents or evidence as the Committee determines should not be published.

(6) That the Committee report to the Senate as soon as possible.

(7) That the foregoing provisions of this resolution, so far as they are inconsistent with the Standing Orders, have effect notwithstanding anything contained in the Standing Orders.

The motion was supported by all parties and on 9 April 1970 the Senate agreed to a motion that the Select Committee on Securities and Exchange consist of eight Senators, four to be appointed by the Leader of the Government in the Senate, three to be appointed by the Leader of the Opposition in the Senate and one to be appointed by the Leader of the Australian Democratic Labor Party.

On 16 April 1970, the Senate was informed that Senators Sir Magnus Cormack, G. Georges, A.G.E. Lawrie, J.A. Little, P.E. Rae, J.P. Sim, J.M. Wheeldon and K.S. Wriedt had been appointed to serve as members of the Committee.

With his election as President of the Senate on 17 August 1971, Senator the Hon Sir Magnus Cormack resigned and Senator P.D. Durack was appointed in his stead. The present Chairman and the other Senators have served throughout the life of the Committee.

As Committees are appointed only for the life of a Parliament it was necessary that the Committee be reconstituted following dissolution of the 27th Parliament and the meeting of the new Parliament on 27 February 1973. On 10 April 1973 the Senate resolved to re-constitute the Committee with identical terms of reference. With the prorogation of the Parliament on 14 February 1974 it was again necessary for the Committee to be re-constituted. This was done on 14 March 1974, again with the same terms of reference.

PREFACE

Meetings of the Committee

Since its first meeting on 21 April 1970 the Committee has met on 167 occasions. Evidence amounting to more than 12,000 pages of typed transcript, of which approximately 25~ was heard *in camera*, was taken at 86 meetings held primarily in Canberra, but also in Perth, Sydney and Melbourne. The 142 witnesses, drawn from all sections of financial and commercial life in Australia, included representatives of various regulatory bodies and government institutions related to the industry, University lecturers, stock exchange members and executives, stockbrokers, Companies Act registrars, managers of mutual funds and other institutional investors, company directors, financial journalists, accountants, company secretaries, geologists, engineers, representatives of life offices, and shareholders. (There is an alphabetical list of witnesses at the end of this Report.)

In addition the Committee received many hundreds of letters and oral and written submissions from private individuals and professional bodies throughout Australia.

The Committee is grateful for the assistance given to it and for the widespread public interest in its work.

Reports to the Senate

On 15 May 1971, the then Chairman, Senator the Hon Sir Magnus Cormack, K.B.E., made a statement to the Senate on the Committee's progress to that date. Subsequent statements were made by the Chairman of the Committee, Senator P.E. Rae, on 9 December 1971 and on 13 December 1973.

From time to time the Committee considered whether it should table an interim report but, as outlined in each statement to the Senate, the Committee's opinion was that the inter-relationship of the various aspects of the inquiry was too great for part-presentation at that stage.

The Committee decided to publish this report without awaiting the completion of a chapter on matters relating to certain announcements and geological assessments by Queensland Mines. We believe however that this chapter provides important insights into Stock Exchange and Company practices as well as providing lessons related to the supervision of the securities industry. It will be published as soon as possible.

This publication is also without the final chapter relating to further, but less important, recommendations of the Committee. That chapter will also be tabled in the Senate as soon as possible.

In both instances the early drafts have been completed. However the Committee desired to give further consideration to them and to have them extended.

In taking its decision to table the Report in its present form the Committee recognised the keen interest of the Senate and was aware of the importance of taking the earliest opportunity to provide the major parts of the report to those concerned with the introduction of new laws governing the securities industry and to the public.

The Committee believed that the integrity of the Report would not be destroyed by its publication without those chapters, though we emphasise that the final printed report must contain them.

This report refers extensively to documents received by the Committee. To ensure that readers have the fullest understanding of such references, the documents are being published in full in a companion volume.

The transcript of public evidence given by witnesses is also being published. It is contained in three volumes. The transcript of evidence does not contain the evidence taken in camera. A variety of circumstances led the Committee to take evidence in camera from time to time. In many instances witnesses were clearly advised that, even though the evidence was taken in camera, the Committee reserved the right to use some of this evidence in the report itself. The report includes a number of quotations from such evidence. In other instances the witnesses have subsequently given their approval to the use of parts of their in camera evidence.

Overseas Information

To keep informed on current thinking and developments within the securities industry, the Committee sought and obtained extensive information from overseas countries, in particular, the United Kingdom, South Africa, the United States of America, Canada and Japan. Various reports of governmental and other inquiries overseas have been of considerable assistance to the Committee. In addition the Chairman, Senator P.E. Rae, the Legal Adviser, Professor D.E. Harding and the then Secretary, Mr D.W. Whirbread, have been overseas during the course of the Committee's inquiry and have had valuable discussions with experts in the securities industry in the United Kingdom, the United States, South Africa and Canada. In particular, they have had an opportunity of seeing the U.S. Securities and Exchange Commission and bodies such as the London, New York, Johannesburg and other Stock Exchanges in operation and have brought the benefit of this first-hand experience to the Committee's deliberations.

The Committee wishes to express its gratitude for the ready co-operation given by various overseas individuals and bodies, especially to officers of the United States Securities and Exchange Commission, to Professor Louis Loss, Professor of Law at Harvard University and to Mr James J. Needham, Chairman of the Board of the New York Stock Exchange.

Officers of the Committee

At the first meeting of the Committee on 21 April 1970, Senator the Hon Sir Magnus Cormack, K.B.E., was unanimously elected as Chairman and continued in this position until 17

August 1971 when he was elected to the position of President of the Senate, whereupon he tendered his resignation.

On 18 August 1971 Senator P.E. Rae was elected unopposed as Chairman.

Mr D.W. Whitbread, Clerk of Committees, was appointed Secretary of the Committee at its inception on 19 March 1970 and served in this capacity until 30 January 1974. Mr J.M. Collins served as Assistant Secretary/Research Officer to the Committee from 18 May 1970 to 11 August 1971 and Mr B.J. Knox from 9 December 1971 to 22 June 1975. Mr D.V. Selth and Mrs M. 0'Dea assumed the positions of Secretary and Assistant Secretary respectively from 51 January 1974.

At various stages during the course of the inquiry, Mr H.L. Williams, Mrs J. Bailey, Mrs E. Hamilton, Mrs M. Hobson, Miss J. Kelly and Miss M. Walters provided clerical and secretarial assistance.

Recognising the complex and technical nature of the inquiry, the Committee agreed that it should appoint qualified and experienced advisers.

On 24 June 1970, Mr D.E. Harding, Senior Lecturer (Commercial and Securities Industry Law), Australian National University, Canberra (now Professor of Law, University of New South Wales) was appointed part-time Legal Adviser. During his sabbatical leave in 1972 Professor Harding visited both the United States and United Kingdom and made an extensive study of the operation of the securities industry and its regulation in those countries.

On 15 July 1970, Dr P.J. Rose, Senior Research Fellow, Institute of Applied Economic and Social Research, University of Melbourne, was appointed as Economic Adviser and since 1 August 1970, has, with one short break, worked full-time with the Committee as Adviser, Research Co-ordinator and Principal Reporter. We are particularly grateful to the Institute for their ready co-operation in agreeing to Dr Rose's secondment to the Committee for the duration of the Committee's inquiry.

On 26 August 1971, Mr J.F. Mc0uat, Vice-President, Watts, Griffis & Mc0uat (Aust.) Pty Ltd, was appointed as Geological Adviser. On Mr Mc0uat's return to Canada, Mr T.V. Willsteed of the same Company continued to act in this position. The choice of geological advisers was influenced not only by that Company's position as one of the leading consultants in Australia but also because of its wide international experience, especially in North America.

On 23 February 1973, Mr T.M. Fitzgerald, B.Ec., former Financial Editor of the Sydney Morning Herald, and former Editorial Director for News Ltd, was appointed as an adviser and continued in that position until 20 August 1973.

Acknowledgements

The Committee wishes to express its sincere appreciation to Professor G. Blainey, Mr A. Aftermann, Mr R. Allen, Mr M.G. Lincoln and Mr P.M. Norman, all of Melbourne University, for their assistance to the Committee at particular stages of its inquiries and report; to Mr E. Niemann of Hungerford Spooner and Kirkhope; to the President of the A.A.S.E., Mr M.I. McAlister; to Mr J.H. Cooper, Chairman of the Sydney Stock Exchange and Sir Cecil Looker, Chairman of the Melbourne Stock Exchange, and other members of Australian Stock Exchanges; to relevant Commonwealth and State Departments; to members of the securities industry and to the legal profession - in particular the constitutional lawyers, Professor Colin Howard, University of Melbourne, Professor P.H. Lane, University of Sydney, Professor Geoffrey Sawer, Australian National University, and Professor Leslie Zines, Australian National University, who provided the Committee with opinions in relation to the constitutional aspects of Commonwealth power.

As already mentioned, the Committee developed the practice of involving highly qualified and experienced advisers to assist in various aspects of its inquiry and report. We are most grateful to each such adviser for his valuable assistance but wish to make particular reference to the contribution made to our work by Dr John Rose. His combination of academic brilliance, practical experience and untiring hard work has been invaluable.

The Select Committee has the honour to present to the Senate the following unanimous report.

P.E. Rae
Chairman

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CHAPTER 1
INTRODUCTION

The main finding of this Committee is that the regulation of the securities markets, of the intermediaries which operate in these markets, and of some of the activities of public companies and investment funds, is in need of fundamental reform. Our essential recommendation is that an Australian Securities Commission be established forthwith by the Federal Government to carry out this reform. Securities markets have an important part to play in the development of Australia and effective regulation is required to ensure that the markets are functioning to achieve this objective.

In the preparation of its Report, the Committee has given careful consideration to questions concerning the form and content it should have in order properly to fulfil the Committee's terms of reference and substantiate the findings and recommendations. This necessarily included a consideration of the proper extent of the protection to be given to the interests of persons and business firms whose affairs have come under examination in the course of the inquiry. We have sought and been offered spontaneously a number of opinions on the relevant issues.

It should be said at once, that it is certainly not the prerogative, nor can it be the desire, of this Committee to withhold relevant information from the knowledge of Senators or the public, however unexpected and even startling some of the information may be. The Committee was in no position to entertain pre-conceived ideas at the outset of its inquiries regarding conditions in an industry in which there had not been any intensive examination, whether of an internal or external character. Nor was anybody else in a position to hold preconceived ideas, though we were repeatedly assured in the early evidence from two stock exchange chairmen that their markets were practically free from abuse. This Committee is not responsible for the existence of facts. It has borne a responsibility to ascertain facts and, having done that, to record them in the interests of helping to promote an adequate understanding of the securities industry.

The Committee has kept in mind that the object of its inquiries was not to pass judgment on any particular persons or firms but to assess the adequacy or otherwise of operations and general standards in the securities markets under the present regulatory authorities. Hence, whenever an examination was made into the activities of a firm or company, we were concerned to know what action had been taken by the various regulatory authorities in connection with any injurious practices revealed, or what regulatory procedures were in operation to guard against such practices. For example, in the first of the case studies in this Report (Poseidon), after a detailed discussion of our findings, we have examined at length the failures of the stock exchanges and the State authorities to take any effective action to regulate the practices described. The other case studies have been dealt with in a similar way. While we have expressed our concern and, in some instances, alarm at the actions of people in relation to certain practices, our overriding objective has been to find out what steps, if any, were taken by the regulatory authorities to check the practices described.

Some of these practices which we have investigated appear to be of long standing, and we recognise that those engaging in them may claim that all the existing authorities have permitted the practices, to the extent that the authorities were aware of them.

The Committee's investigation has necessarily been somewhat selective. Though it might appear to have had the character of a random 'spot audit', in fact it was considerably more than that: the Committee was able to relate events occurring during the course of its inquiry to the general background plan of work it had prepsred for the investigations; it was able to select the developments which it considered most relevant to its objectives, and it modified the plan in the light of these developments. Thus, to take just one matter, from the early stages of inquiry it had been our intention to inquire into the share-trading activities of employees of stockbroking firms. The investigation into the affairs of Melbourne stockbroker, John T. Martin & Co., began with the objective of finding out the circumstances in which that firm failed, but in the course of this particular inquiry extensive evidence was also obtained on employees' share trading (as well as on many other matters, see Chapter 4). Well before the crash of the Minsec group of companies, we had planned to take evidence from them on the activities of large-scale corporate share traders. Following the group's collapse, we widened this inquiry to include the Minsec mutual funds, for the role of such funds in the market had also been high on the list of matters we wished to consider.

It is nevertheless true that the affairs of some firms were examined in more detail than those of others, and we cannot, and do not, say that the practices discussed in the Report and in the evidence were carried out only by those firms mentioned. Indeed, we have good reason to believe that some of the practices have been widespread. Being a Senate Committee inquiry, the procedure followed in the assembling of evidence was not the same as proceedings in a Court of law. However, we have been aware that the publication of material obtained in this inquiry can affect the interests of some of the persons concerned.

The content and character of our Report have been conditioned by these considerations. But it has not been determined exclusively by them, and it is necessary to indicate why this could not be the case.

This Report, like our inquiries, deals substantially with developments which arose after the Committee was established or which continued during the course of the investigation, when everybody associated with the securities market could be presumed to know that the inquiry was in train. In that sense, nobody was taken unawares. It might rather have been expected that especially careful standards would be applied from the date early in 1970 when it became known that the Committee was preparing to carry out its investigations. It might be inferred that activities in the industry from that time would be regarded by the practitioners as being fully defensible in any subsequent public discussions. It is not really a qualification in principle to note that the Committee found some witnesses before it to be less than candid and accurate in their testimony; and it would obviously be incongruous to accept that as a reason for not seeking out the truth where necessary. This process of checking evidence in fact involved the Committee in a large amount of additional work and extended the time taken to complete various inquiries well beyond our initial expectations.

For the purpose of providing illustrative material, we have drawn as much as we reasonably could on the histories of firms which have recently gone out of business. But there are limitations on the use that can be made of such examples; the records of failed firms are not necessarily representative of the industry as a whole, even though they throw light on the scope that existed for certain practices. Some of the most important issues arising from our inquiry could not be explained or discussed merely by reference to firms which have become defunct. A substantial amount of other illustrative material was needed.

The reporting in the Press and other media of the open hearings of this Committee has already included references to some of these matters and the persons and firms concerned.

The overriding duty of this Committee has been to inform and advise the Senate and the general public of the measures which it considers necessary to develop the securities market in the best interests of all those who wish to use it and of an efficient economy. The importance and seriousness of the issues cannot be appreciated without a concrete understanding of circumstances which exist. We believe there is evidence to show that this understanding is not yet as extensive as it should be. The evidence lies partly in the continuance of some practices which we have critically examined and partly in reaction to an interim statement made by the Chairman of this Committee on 9 December 1971 when he announced some of the broad conclusions the Committee had reached at the end of its public hearings. We do not question the right or the good faith of those who have challenged those conclusions, but it is far from evident that they are based on a full understanding of the facts or the limitations of the existing forms of supervision over the securities market to deal with actual circumstances. It has therefore been necessary to provide a substantial amount of specific information to substantiate the Committee's findings.

For several years before this Committee began its work there had been available some highly relevant information on the operations of the securities markets and of stock exchange firms in Australia. We refer in particular to the Report in 1967 of the investigation under the Companies Act in Victoria into certain transactions in the shares of Cox Brothers (Australia) Limited involving the firm of Ian Potter & Co. and its financial associate Australian United Corporation; the Reports (1964, 1966 and 1967) of the investigation under the Companies Act in Victoria into the affairs of the Stanhill companies in which there is a detailed discussion of the roles of broker-underwriters in new issues and the suggestion made that these two functions be separated; and case of Hewson v. Sydney Stock Exchange Ltd [1967-68] 87 W.N. (N.S.W.) Pt.1 422, in which Mr Justice Street criticises in forceful terms the practice of stock exchange firms trading in shares while concurrently advising and acting for clients. During the course of our inquiries, we also noted the case of Vam Limited v. McDonald Industries Limited & Ors [1970] N.S.W.R (3)3, in which an arrangement was made between Ralph W. King & Yuill, members of the Sydney Stock Exchange, and McDonald Industries, which had the effect of McDonald putting the broker in funds to enable the broker's nominee company (Ralphking Nominees Pty Ltd) to take up McDonald shares for eventual placement with its clients. Important information was also obtained from the Tasminex Report (1970) which discusses in detail the trading in the shares of that company during the period November 1969 to March 1970.

While we studied these reports and cases and used the information to guide our own inquiries, it is still true to say that there was no substantial body of information which had been collected on the workings of the securities markets. In particular, the stock exchanges were unable to provide us with any aggregate statistics on many important matters affecting their activities. We therefore adopted the case work approach we have described while at the same time we carried out a wider survey and analysis of the pertinent data we had collected from the balance sheets and accounts of all stockbrokers in Australia. To some extent we conducted a number of sub-studies of the data included in the brokers' accounts. All the results are contained in Chapter 3. The limitations of time and resources prevented a fuller and more detailed analysis of this information, but we hope it will be the first of a continuing series of such studies to be carried out by the commission we recommend in order that market regulation may in the future be based upon a sound knowledge of industry trends. Although this Report is the first account of an inquiry in depth into the operations of the securities market in Australia, we must point out that many such inquiries have been undertaken in overseas capital markets.

It is true that this Report is largely concerned with practices which occurred during an exceptional boom in the shares of mineral exploration and mining companies. The evidence reveals a picture of a market distorted by a degree of speculation that may rank with the excesses of earlier booms in Australia's history. As one witness said: 'I think we all believed that Australia was full of nickel under every hole'. He recalled how 'chartists bobbed up everywhere ... rumours abounded, markets surged. They became ridiculous.' In this market climate, unprecedented opportunities were afforded for a minority of corporate promoters to develop tortuous schemes and devices to exploit an investing public that was often buying blindly in ignorance of the underlying weaknesses of the market. Although the period of intense speculation passed in 1970-71, and the new issue boom which brought into existence about 249 mineral companies collapsed at the same time, the changed circumstances do not mean that there are no important lessons to be derived from a detailed study of the market during that period.

In the first place, it is in circumstances when the market is busy that the willingness of the various market institutions and firms to meet their public responsibilities is tested, for it is then that the opportunities for abuse and the adoption of low standards are more readily available. Such a market also provides an occasion to test the appropriateness of various securities laws and the effectiveness of the regulatory authorities in policing those laws.

One of the aspects of the most recent boom which has concerned the Committee has been the activities of some broker-underwriters. It should first of all be said, that it is common in Australia for brokers to act as underwriters - indeed, a small number of stock exchange firms played an important role in the development of the new issue market. In the new issue boom (1968-69 to 1970-71) brokers continued to act as underwriters and, of the 249 companies floated during that period, about 184 were underwritten by stock exchange firms (120 in Sydney, 26 in Melbourne, 16 in Perth, 12 in Brisbane, 8 in Adelaide, and 2 in Hobart). In acting as underwriters some of these firms exercised careful judgment in determining which companies they would support for public listing. In doing so they played a useful role in assisting small companies to raise public funds to carry out exploration. To a regrettable extent, however, the excesses of the boom were not only fostered by some broker-underwriters, but were initiated by them. These firms gave minimal attention to the soundness of the ventures they were supporting. They encouraged public support for the companies, not only by underwriting them, but by publicising and recommending the shares in their newsletters and other publications. A number of brokers were also deeply involved in the companies as promoters, directors, investors and large share traders. In certain share offerings substantial numbers of the shares were 'shelved' while demand was being stimulated by trading activities, publicity and solicitation of customers. Withheld shares were then sold to customers at premium prices in what amounted to a redistribution of the shares offered. One broker-underwriter informed us in a submission that in more than one flotation for which he was the underwriter he had financed the promoters and directors into large purchases of the shares. This practice occurred in the flotation of Antimony Nickel, and in that instance it was not disclosed in the prospectus that a large number of shares had been taken up by the directors with funds lent by the underwriter. We noted that in the post-issue market the broker-underwriter sold some of these shares (which had been held in the broker's nominee company) at prices well in excess of the issue price. The market was not informed of the nature of the sales taking place. Those who gained from such activities were the underwriters, insiders of the companies, and favoured customers of the underwriters and promoters (who in some cases also benefited from the tax concessions available to those who subscribed to the new shares). The losers were those investors who purchased the shares at inflated prices in the post-issue market.

Many disturbing aspects of this new issue boom came to our attention and, up to the final stages in the preparation of this Report, we were receiving a steady flow of complaints and new evidence of practices detrimental to the public. We have also noted that in the relatively quiet market after the boom there have been instances of market activities calling for further investigation. Some of the practices have been associated with takeovers, a subject which has not received any sustained attention in this Report. To discuss all this information would have taken far more time than was available to the Committee and we have of necessity had to be selective in the evidence presented. It has not been possible, for example, to discuss the blatant abuses and fraud uncovered in the well-known Leopold Minerals N.L. case. It has not been the function of this Committee to investigate every abuse which has been brought to its notice. We selected our case studies with the objective of bringing to light a sufficient number of different types of practices so as to demonstrate the need for change in regulatory procedures.

It is now clear that a high proportion of the several hundred millions of dollars raised during the boom years was never spent on mineral exploration or development. Evidence to support this conclusion is to be seen in a study by Dr R.B. McKern of

100 mineral companies operating in Australia over the period 1964-70. It can be inferred from this study that 'the very small companies (with assets under $1.5 million) which constituted the majority of Australian mining ventures employed on average only 27 per cent of the funds raised by them in exploration or in developing mines and purchasing plant (paper presented at Annual Meeting of the A.I.M.E., San Francisco, February 1972). Many of the accounts of these companies which were floated just a few years ago also reveal huge losses from activities other than mineral exploration. In a number of cases only detailed investigation would reveal how such losses have been incurred. Already quite a number of the companies have had their shares suspended from stock exchange trading or have been delisted. The recent reports in New South Vales of the Special Investigation into the Barton Group of Companies record enormous losses of funds raised by these companies from the public. It can hardly be disputed that many of the so-called mineral exploration and mining ventures promoted and floated on the stock exchanges during the boom were totally unsuitable for public financing. Too often the directors were either unaware of their public responsibilities or adopted a cynical or cavalier approach to those responsibilities. Further, it is our view that some stockbroking firms must be criticised for adopting such low standards of underwriting; similarly, the stock exchange committees must be criticised for agreeing to list such companies. In every instance, of course, the prospectuses of these companies were registered with the State Companies Offices so these bodies must also be censured for allowing unsuitable companies to reach the public market. While there was a gradual upgrading of listing requirements as the boom progressed, most of the changes were made after many of the unsuitable companies had entered the lists.

It should also be noted that much of this Report is not concerned with the affairs of small mineral exploration companies.

In several chapters attention is directed to the activities of large corporate groups which, at the time, were in high standing in the financial markets in Australia and overseas. The chapters on Minsec and Queensland Mines come into this category. In addition, we have shown how some of the abuses involved in private placements of small speculative mineral companies were also to be seen in the placements of the large industrial company, Swan Brewery Company Limited (see Chapter 10). Most of the evidence relating to the private share issues discussed in Chapter 10 was taken during 1972o

Moreover, as we have said, many of the unsatisfactory practices described in this Report occurred while this Committee was conducting its broad inquiry into the securities market and known to be doing so. For example, some of the Swan Brewery placements which we have criticised took place after this Committee was established and continued into the second half of 1972, well after we had finished taking public evidence. It would appear that no investigatory body can ever assume that the mere fact of its existence is sufficient to drive out malpractices and to raise standards to the desired level.

In order to complete our studies, it was necessary to collect a large number of documents and, in some instances, take further evidence. Some of the documents accompany this Report in a separate volume. Our purpose in analysing in depth a selection of the cases which came to our attention has been to lay the foundation for remedial action in the areas explored. In the case of the stock exchanges, this purpose has, to a limited exten~ been achieved as a result of some changes they have made in their regulatory procedures. However, we remain firmly of the view that these changes do not go far enough.

In view of the fact that a substantial part of this Report deals with the affairs and shortcomings of some stockbrokers, the Committee wishes to make clear that, in the course of its inquiries, it also found members of stock exchanges who did maintain high standards of integrity in running their firms. In addition we received guidance and assistance from members of stock exchanges who have been concerned about certain practices in the market and departures from ethical standards.

In seeking information on the operations of the markets, we deliberately sought evidence from a wide range of financial intermediaries. An aspect of this evidence to which we draw particular attention is that the various financial institutions, companies and firms in the market have tended not to specialise in one or a few functions, but to have spread their interests to carry out numerous activities, many of them impinging in different ways on the share market. This evidence has also illustrated another general point concerning the market as a whole. As the different participants in the securities market have diversified their interests, so the inter-linking of the institutions and financial firms has increased, giving rise to a range of intricate market practices which create regulatory problems.

In Chapter 7, for instance, we show how, in a variety of questionable ways, the activities of an investment consultant were inter-related, one activity tending to support another, so that the share-tipping in the consultant's newsletters focused, at the appropriate time, on the stocks which a public company associated with the consultant was buying for share-trading purposes. It was also noted that the consultant's interest in the public company whose share trading he was supporting through market circulars was not as a shareholder, but as a large holder of options. Complementing some of these activities on various occasions were undisclosed links with stockbrokers, who are also shown in Chapter 7 to have far-reaching interests in the securities market.

Chapter 14, Minsec, illustrates the close links between merchant banks and stockbrokers, and shows how large speculative dealings on the share market were financed with short-term funds drawn from the unofficial money market and the inter-company market.

It is probably true that the need for safeguards against undesirable activity has increased considerably as the result of the development of relationships of the kind we have described, though we would add that such integration does not necessarily lead to abuse. What we are more certain about, judging from our own experience, is that in a complex national securities market such as Australia's, with many of the participants in the market inter-related across State boundaries, and with market transactions capable of being organised and channelled in innumerable ways, there is a constant problem of detecting when questionable practices are taking place. Even to unravel an inter-related series of transactions well after they have occurred and have in fact been partially exposed is a painstaking and lengthy process. In our view this regulatory problem will continue, for it is likely that many of the financial companies and firms that operate in the markets will go on developing new functions, relationships and practices as they respond to new needs, influences and opportunities. If the regulatory authorities are to adapt their procedures to these changes, it will be important to follow and understand them as they are happening. It will be necessary to review carefully institutional or legalistic classifications that can rapidly become out-of-date, and market developments should be studied in their national context, not from what may be the relatively restricted and necessarily limited viewpoint of one city or State.

CHAPTER 2
INSIGHTS INTO THE POSEIDON BOOM

Genesis of a Boom, Beginning of an Inquiry

The announcement to the Stock Exchange of Adelaide on 1 October 1969 that a small, relatively unknown mineral explorer by the name of Poseidon N.L. had struck 40 feet of massive sulphides assaying 3.56 per cent nickel and .55 per cent copper at Windarra, Western Australia, was the genesis of probably the greatest speculative share boom in Australia's history and, perhaps, one of the most remarkable which the world has experienced. Mineral share prices had been high before this date, having risen dramatically between mid-1967 and August 1968, but for a period of about a year there had been no sustained rise, and for some months market prices had been drifting downwards. With the announcement of this strike, however, the market responded with an astonishing degree of excitement. On 24 September 1969, the day Mr Godfrey Hyde Ruthyen Burrill~ Poseidon's consultant geologist, observed the percussion drill disgorge the massive sulphides of nickel and copper from the discovery hole, the Sydney Stock Exchange share price index for non-ferrous metals was 3892. One week later, the index was 3980. At the time of Poseidon's triumphant annual general meeting, on 19 December 1969, when the chairman told expectant investors throughout the world that a major mine would be established, the index reached 5101. Then, during the next ten days, the index swept up to an all-time peak of 5870, which was a rise of more than 50 per cent in about three months.

However, the percentage increase in the value of Poseidon's own shares far exceeded the general market rise, so that to an extraordinary extent the daily market movements in the Poseidon share price became the subject of general public interest. For instance, soon after the announcement of the discovery, Mr T.A. Nestel appeared on the Australian Broadcasting Commission's national television program, 'This Day Tonight', in order to comment on the day's share market. Mr Nestel was managing director of Mineral Securities Australia Ltd (Minsec), which was an extremely large corporate share trader. Elsewhere in this Report we discuss some of the techniques employed by the Minsec group in its share dealings, but here we note that, at the time, many people, including stockbrokers, listened to Mr Nestel's comments with respect. During the television program, Mr Nestel discussed how Minsec had bought 5,000 Poseidon shares that morning. He was reported as saying that he regarded the day's trading as 'a most impressive performance', indicating that there was 'far more than speculative fever underpinning Poseidon in particular and the mining market in general'. Poseidon's share price had closed at about $27, well above the lowest price for the day of $20. His assessment of the potential of Poseidon was that it 'could be another small Western Mining giving the shares a present value of $80' (see Sydney Morning Herald, 17 October 1969). Mr Nestel's reputation as an oracle on movements in share prices was greatly enhanced by this estimate, for after two months the price had passed well beyond $80.

From the earliest stages of their climb in price Poseidon shares were the subject of international comment. In November 1969, for example, The Times observed that Poseidon was 'the share of the year - if not of all time as far as stock market performance is concerned'. The accompanying warning that 'in reality' the share price was 'still not tied to anything concrete', and that the share was 'not a good investment for the private shareholder', went unheeded as much in London as it did in Australia. The shares, which had been selling for about $ 1.10 before the strike, continued to rise in price through December and January, until a peak of $280 was reached on 10

February 1970. A total of 2.04 million shares had been on issue at the beginning of this period, but there had been a substantial watering of this issued capital arising from a placement of 4 500,000 new shares for $2.8 million - a placement allegedly arranged before the assay results were known. We will be commenting upon this placement and showing that the company's consulting geologists and one of the directors, Mr Norman Craig Shierlaw, who was also a member of the Adelaide Stock Exchange, arranged the placement to their associates after they were aware of the first assay results indicating the significance of the nickel discovery but before the public announcement of those results.

The effect of the spectacular rise in the Poseidon share price to $280 was to increase the market value of the company from about $2.2 million before the strike to about $711 million. But in the eyes of some brokers, even this valuation was below what they believed the company was worth. For example, one London broker, Panmure Gordon & Co., published a review, in January 1970, which was circulated and quoted fairly widely in Australia, saying that in their opinion 'on a present value basis discounting at a rate of 8% a year, the shares are estimated to be conservatively worth $500 and more optimistically $582'. These brokers pointed out in their detailed and, apparently, well-informed review of twenty-three pages that, following the intersection of massive nickel sulphides in September 1969, they had twice visited Australia, on the first trip 'to see the Windarra property, amongst others', and on the second trip 'to attend the Annual General Meeting'. 'Poseidon' they said, 'has changed from being a relatively small, unknown exploration company into a development company of world wide interest'. They forecast nickel ore production of 500,000 long tons in 1971-72, rising to 1,000~000 long tons in 1972-73. Net profit was expected to be $10.2 million in 1971-72, and $22.7 million in 1972-73.

(At the time of writing, late 1973, after taking over two companies for the issue of about 692,000 shares and placing and issuing a further 625,000 shares, Poseidon was valued in the market at about $27 million, the shares being quoted at about $7 each. The company recorded a loss in 1971-72 and a small profit in 1972-73. Production from the nickel mine was expected to begin in late 1974.)

It is scarcely surprising that from October 1969 through to the autumn of 1970 there were almost daily references in the Press t~ the Poseidon boom, and that general market movements in share prices became closely linked with the fluctuations in the price of Poseidon shares. Investors' faith in the ability of the small type of company to explore successfully and to match the expertise of the national and international giant corporations in the expensive and hazardous activity of mineral exploration seemed justified by Poseidon's experience. For three months before the strike, the financial resources available to Poseidon for exploration were only about $500,000. It owed its success, firstly, to the initiative of a prospector, Mr K.G. Shirley, who had explored in an area where the geological environment was different from that where commercial deposits of nickel had already been discovered and, secondly, to the willingness of the directors to risk the company's funds in drilling on a prospect that other geologists did not rate highly. In Mr Burrill's words:

Without being wise after the event, there were a number of senior geologists of other companies who considered that we had no chance. We offered it to some major mining companies and they considered the environment was totally wrong. So we had everything going for us at the site, except for the fact of the geology of it. It was, as I said, a completely different type of geological environment from anything that had yet been found in Western Australia.

(Ev. 2996)

There was a spurt in the pegging and sale of mining claims, especially in the Windarra area, and dozens of new mineral exploration companies were rapidly promoted and floated on the stock exchanges, mostly with the support of stockbrokers acting as underwriters. Large amounts of public funds were raised. In addition, many listed mineral companies, again with the assistance of stockbrokers, followed in the footsteps of Poseidon and seized the opportunity to replenish or add to their capital funds by the 'placement' of large quantities of new shares. Information collected by the Committee showed that the market in Poseidon shares during this period included very large professional share traders, associated with stockbrokers and corporate groups, dealing in many millions of dollars. But thousands of individual investors and speculators were also involved. Well after the boom (and after the takeover of another company, Lake View & Star), it was revealed that, out of about 20,000 shareholders in the company, more than 11,000 owned less than 20 shares each.

With numerous stockbrokers and tens of thousands of investors and shareholders experiencing an exuberance of confidence in their ability to make fortunes on the stock exchanges, the mood of the market was not one in which critics of stock market practices or the stock exchange authorities could expect a ready hearing. Yet there were such critics, one of the most persistent and perceptive of whom at the time of the Poseidon discovery was the financial editor of the West Australian, Mr John Henry Laurence, who called for an inquiry into the active trading in Poseidon shares which had taken place just before the announcement of the discovery. Further questions began to be asked when the market was informed of some of the circumstances in which the placement of 500,000 new Poseidon shares had been made, at an advantageous price largely to companies associated with some of the directors. When one former shareholder in Poseidon, Dr Max Kimberley Anderson of Perth, failed to obtain what he believed to be adequate response from the Perth Stock Exchange chairman, Mr G.I. Hynam, and the Adelaide Stock Exchange president, Mr D.I. McArthur, to his concern about the nature of the trading in Poseidon shares and the state of knowledge of the market before the discovery was announced, he wrote to Senator Murphy. In a speech in the Senate on 19 March 1970, Senator Murphy made extensive reference to Dr Anderson's complaints about the possibility of insider trading and to the unsatisfactory replies which Dr Anderson had received from two stock exchanges.

Some months later, after this Committee had been formed, it was decided to inquire into the alleged insider trading in Poseidon shares and, at the same time, to seek evidence from the authorities in Perth on their procedures for regulating the share market. Paradoxically, the final examination undertaken by the Committee was concerned with the same subject, the reason being that, while concluding an investigation on another matter towards the end of 1972, we came across evidence which cast serious doubt upon the reliability of much of the earlier testimony on the trading in Poseidon shares. When further research revealed that we and the public had been consistently misled, a decision was made to reopen the inquiry.

In the following sections of this chapter we set out, first of all, a summary of the significant events with which we are concerned. Next, we discuss certain aspects of the business of Poseidon's geologists and report upon various share dealings, among which we include the extensive purchases of Poseidon shares~ by the geologists and the broker who was also a director of Poseidon. These purchases took place after the nickel and copper sulphides had been discovered but before the announcements of the discovery to the public. The discussion is also concerned with a long series of misleading reports and statements by the directors and geologists to shareholders and the stock exchanges. We then proceed to examine the evidence received from the stock exchanges as to why they did not investigate any of these matters. In a concluding section we bring together the various lessons to be derived from this study.

Summary of Significant Events: the Elusive Truth

1969 11 February:	Poseidon N.L., a company based in Adelaide, reported the acquisition of claims in the Laverton area, Western Australia, which the directors regarded 'highly'.
11 April:	Poseidon's consulting geologists, Burrill and Associates Pty Ltd (a company owned and directed by Mr G.H.R. Burrill and Mr W.R.K. Jones), sent a typed report to Poseidon on the results of their inspection of the company's properties in the Laverton area (Committee Document 2-1). In respect of the 'Windarra group' of tenements, the geologists reported values in a gossan of 0.50 per cent copper and 0.70 per cent nickel. They described the tenements as 'very encouraging' and 'intensely interesting'.
24 to 29 April:	Burrill and Associates bought 10,000 Poseidon shares at prices rising from 60 cents to $1.20 for their associated share-trading and investment company, Burrill Investments Pty Ltd. All the shares were bought through Mr N.C. Shierlaw, a member of the Adelaide Stock Exchange, who was also a director of

	Poseidon and that company's chief public spokesman.
29 April:	Poseidon reported the pegging of further claims in the Laverton area and said that the company's geologists regarded some of the claims as 'encouraging'. The directors also said that they knew 'of no other reason for the sharp rise in the quotation for the company's shares'. This announcement did not refer to the geologists' buying of the shares.
April - May:	Between 18 April and 15 May, Mrs G.I. Hynam, the wife of the chairman of the Perth Stock Exchange, was allotted new shares in Burrill Investments Pty Ltd and so became the holder of 9 per cent of that company's issued capital (Ev. 477 and 483). Mr G.I. Hynam was a close friend of Mr W.R.K. Jones (Mr Burrill's associate in Burrill and Associates) and also acted as his broker (Ev. 477).
14 May:	Poseidon directors reported that they had 'instituted an exploration programme' recommended by the consultants on the areas at Windarra and Rowena.
11-19 June:	Burrill Investments Pty bought a further 15,900 Poseidon shares at prices between 70 cents and 90 cents; 10,000 of these shares were bought through Mr Shierlaw's firm.

24 June:	Poseidon reported that 'initial work' had commenced on the exploration program at Windarra.
26 June to 1 August:	Magnetometer and geochemical surveys were carried out on Poseidon's claims and the induced polarisation survey was commenced.
10 to 29 July :	Burrill Investments Pty bought a further 4,100 Poseidon shares at 80 cents. Mr G.I. Hynam's wife bought 2,000 Poseidon shares at the instigation of Mr Hynam (Ev. 493).
Late August:	By this time,according to Mr Burrill, the trenching was finished on the prospect at Windarra near Laverton and he was of the view that Poseidon had 'an absolute top prospect' (Ev. 2996).
29 August to 16 September:	Mr K. Biggs, the owner of the pastoral lease on which Poseidon held these promising nickel claims, purchased 9,100 Poseidon shares at prices rising from 72 cents to 90 cents a share for a proprietary company which he had just acquired for the purpose of buying shares.
12 September:	Poseidon reported that it was commencing 'a percussion drilling programme at Windarra'.

23 September Tuesday:	By this time, the first two holes had been completed, PH1 and PH1A. According to the geologists' report to Poseidon directors of 3 October 1969, the first hole 'caved in' at a depth of 45 feet, and the second hole 'passed through oxide zone material and was lost at a depth of 145 feet' (Committee Document 2-2). During the afternoon of 25 September, a batch of samples from the drill cuttings of these holes was sent by plane to Kalgoorlie, about 200 miles from Windarra. The laboratory, Geochemical and Mineralogical Laboratories (W.A.) Pty Ltd (Geomin), was instructed by Mr Burrill (in a letter dated 22 September) to carry out an analysis for nickel and copper by atomic absorption spectrophotometry (AAS). Mr Burrill marked certain samples as 'specials' and said that these 'must be analysed immediately, (see Committee Document 2-5).

Percussion drilling of what was to be known as the 'discovery hole' (PH2) began about midday: 140 feet were drilled between 12.10 p.m. and 6.00 p.mo This hole was about 20 feet away from where hole PH1A had been drilled. Mr Burrill supervised the drilling and was the only geologist on the site.

Poseidon share market relatively quiet: a total of 41,340 fully and partly-paid shares were reported sold by the Australian stock exchanges at prices for the fully-paid shares ranging from $1.15 to $1.20.

24 September Wednesday: Between 9 a.m. and 10 a.m., at a depth of 145 feet, the drill passed into massive sulphides which continued to a depth of about 185 feet. Mr Burrill said he recognised copper sulphide 'very clearly' in the sludge coming from the drill and was 'almost certain' he could see nickel sulphides (Ev. 2996). At this stage, Mr Burrill said he believed that they had discovered an 'exceptional' prospect (EV. 3017).

At 11.30 a.m., the Geomin laboratory in Kalgoorlie informed Mrs Burrill in Perth by telephone of the results of the AAS tests of the 'special' samples (from hole PHIA) which had been sent in for analysis on 23 September. In three samples the nickel content was approximately 1 per cent and in one sample the nickel content was greater than 1 per cent (Committee Document 2-3). The geologists' report to the directors of 5 October stated that the average grade of the 'oxide material' in this hole PH1A 'was approximately 1¼% nickel'.

During the afternoon, Mr Burrill's associate in his geological consulting business, Mr Jones, travelled by air from Perth to Adelaide where he met Mr Shierlaw in the evening and discussed 'the whole Poseidon situation' (Ev. 3088). Mr Jones authorized

Mr Shierlaw to buy Poseidon shares for his account and for Burrill and Associates. (Mr Jones' explanation of his visit to Adelaide and of his buying orders are to be discussed below).

The Poseidon share market remained quiet during the day: a total of 24,300 fully and partly-paid shares were reported sold by the Australian stock exchanges at prices for the fully-paid shares between $1.10 and $1.12.

25 September Thursday: Great activity in Poseidon shares on the stock exchanges: a total of 115,800 fully and partly-paid shares were reported sold by all exchanges in Australia at prices for the fully-paid shares rising from $1.15 to $1.65.

Mr Shierlaw's broking firm bought Poseidon shares (partly-paid and fully-paid) for the following: NCS Securities Pty Ltd, a company controlled and owned mainly by Mr Shierlaw and his family but in which the staff of his broking firm were also shareholders (11,600 shares); Burrill and Associates (4,000 shares) and Mr W.R.K. Jones' account (3,600 shares) (Ev. 3041-42). In addition, Mr Shierlaw bought 2,700 shares for B.R. Lewis Pty Ltd, which was Mr B.R. Lewis' family company. Mr Lewis, at this time, was arranging with Mr Shierlaw for the underwriting and flotation of a company to be called Samin Ltd, which was to become closely associated with Poseidon. Mr Lewis became chairman of Samin and was later to become a director of Poseidon.

Mr Shierlaw also bought 10,100 shares for his 'London Office' account, which was a trading account of his broking firm; 5,000 of these shares were then sold that night to a London broker, leaving Mr Shierlaw the beneficial owner of the remaining 5,100 shares.

Mr K. Biggs bought about 15,000 Poseidon shares for his share-trading company through a Perth broker.

Mr G.I. Hynam bought 2,100 Poseidon shares for himself.

In response to an inquiry by the Adelaide Stock Exchange, Poseidon directors released the following announcement to the Exchange at 1 p.m.

The drilling commenced on the 15th September 1969, but due to technical difficulties only a limited footage has been completed. No assay results are available.

Therefore the Board is unable to explain the sharp increase in the price of the shares.

(In fact, as we have noted, assays of the cuttings obtained from drill hole PH1A had been completed, and these had been released to Mrs Burrill.)

In the field, 56 samples, each covering five feet of the drill cuttings from the hole (PH2) to a depth of about 185 feet, were taken to the Kalgoorlie laboratory of Geomin for analysis of nickel and copper by atomic absorption spectrophotometry. Results were requested urgently 'by Friday morning' the next day. Mr Burrill could not remember how he had had the samples sent to Kalgoorlie, but he thought he might have had them delivered by the drilling company (Ev. 2998).

26 September Friday:

Continuation of a high level of activity in the Poseidon share market: 107,100 fully and partly-paid shares were reported sold by all stock exchanges at prices for the fully-paid shares between $1.40 and $1.94.

Mr Shierlaw's broking firm bought Poseidon shares (partly and fully-paid) for the following: the firm's 'London Office' account (1,600 shares), Mr W.R.K. Jones' account (2,400 shares) and B.R. Lewis Pty Ltd (200 shares).

Mr Burrill received the results of the AAS tests of the samples from drill hole PH2 by telephone and was told that 30 samples had nickel values greater than 1 per cent.

Mr Shierlaw was informed of these results by Mr Burrill during the early hours of Saturday morning, 27th (Ev. 3054).

The price of Poseidon shares rose on the London market that night (Mr Hynam, Ev. 500).

Between 26 and 29 September:	At Mr Burrill's request, an employee of the Kalgoorlie laboratory of Geomin released to Mr Burrill the approximate content of nickel and copper in the samples from drill hole PH2 which contained more than 1 per cent nickel. These AAS readings for the massive sulphides were exceptionally high, some of them being 4 and 5 per cent.
29 September:	Poseidon directors reported to the stock exchanges that 'the second percussion drill hole at its Windarra prospects has encountered nickel and copper sulphides. The assays of the samples will be published as soon as possible'. Presumably, in this stock exchange announcement, the directors meant that the third percussion drill hole, called PH2, had struck nickel and copper sulphides, for in their report to the company of 3 October the geologists said that the second hole, PH1A, encountered 'oxide material' (Committee Document 2-2). At any event, the directors' announcement made no reference to the AAS tests of the samples from PHIA and PH2 which had already been carried out by Geomin.

Fully-paid Poseidon shares sold for prices up to $5.80 a share.

Burrill and Associates delivered to Sheen Laboratories in Perth a parcel of ten percussion drill samples from hole PH2, as well as some soils and rocks. (Some of the rocks were from Mr K. Biggs.) Of the ten drill samples from the Poseidon hole, one covered a 5 foot section of the 40 foot intersection of massive sulphides; the other samples were of the drill cuttings obtained from above and below the massive sulphides. The results of the nickel and copper assays of these ten samples were required urgently, for the next day, 50 September.

Geomin's laboratory in Kalgoorlie was instructed by Mr Burrill to send thirty-one samples of the cuttings it had analysed from hole PH2 to its Perth Laboratory for 'wet assays'.

30 September Tuesday: Fully-paid Poseidon shares sold for prices up to $7 a share.

In the West Australian the financial editor reported:

Let's not beat around the bush. Someone has had information on Poseidon's deposit ... The market buzzed last week with rumours ... yesterday, the rumours became a high-pitched screech that nickel of a richness and volume equal to, if not surpassing, anything yet found in Western Australia, has been found ...

He called for a stock exchange inquiry. The stock exchanges remained silent.

Mr Burrill travelled during the afternoon to Adelaide for a meeting of the Poseidon directors in Mr Shierlaw's broking office (Ev. 3004 and 3007). Mr Jones was also present. At 4 p.m. Perth time, Sheen Laboratories telephoned the results of the nickel assays it had completed that day to Mr Burrill in Adelaide. About one quarter of an hour later, the same laboratory telephoned the results of the copper analysis to Mr Burrill.

During the evening, with the directors' approval, Mr Burrill telephoned overseas to a large Canadian mining company for which he had worked and to a London stockbroker who managed a Fund with which he was associated and offered a total of 100,000 new Poseidon shares at a price of $6 a share.

1 October Wednesday: Poseidon directors issued a report to the Adelaide Stock Exchange before trading began to say that 'Further to the report ... on 29 September ... the assays received to date of the first completed drill hole PH2 at Windarra had shown 3.56 per cent nickel and 0.55 per cent copper for 40 feet

of massive sulphides. Misleading aspects of this report are the subject of a separate discussion in this chapter.

At the same time as announcing these assay results, the directors reported a placement of 500,000 new shares 'to other mining interests' raising $2.8 million.

Following the directors' announcement, the price of the fully-paid Poseidon shares rose to $12 a share.

2 October Wednesday:	Fully-paid Poseidon shares sold for prices up to $17.70 a share.
3 October Thursday:	The market was informed that the purchasers of 200,000 of the new shares which had been placed at a price of $6 a share were North Flinders Mines N.L. (100,000), Nobelex N.L. (50,000) and Australian Development N.L. (50,000). Mr Shierlaw was a director of two of these companies and a shareholder in all three. The Poseidon directors said that they were 'not prepared at this stage' to disclose to whom the other shares had been placed.

Subsequently the market was informed that these other purchasers were Samin Limited, 200,000 shares at $5 each; an overseas mining company, 50,000 at $6 a share; and the nominee company of a London broker, 50,000 at $6 a share. On 50 September, the time the placement was apparently arranged, Samin was not incorporated. It obtained its Certificate of Entitlement to Commence Business and Exercise Borrowing Powers on 10 October. To pay for the shares Samin borrowed $1,000,000 from a bank and this was repaid from capital raised in a public flotation, underwritten by Mr Shierlaw, two months later.

Geomin's laboratory in Perth completed the chemical assays of the cuttings from hole PH2 and forwarded their report to Burrill and Associates. From this report, the geologists and the Poseidon directors learned that their announcement to the market on 1 October that the 40 feet of massive sulphides had assayed 3.56 per cent nickel was incorrect. No steps were taken then or subsequently to inform the market of the correct and lower assay figure.

7 October: The West Australian, in a leader editorial, again called for an investigation by the exchanges into 'the Poseidon affair'. The stock exchanges continued to remain silent.

Price of the fully-paid Poseidon shares rose to $19.

21 to 30 October: Burrill Investments Pty sold 3,000 Poseidon shares through Mr Shierlaw's broking firm at prices between $26.50 and $36 a share, realising $103,922.

During November: Mr Hynam, chairman of the Perth Stock Exchange, was told that he would receive an allocation of shares at the issue price of 50 cents each in the forthcoming flotation of Samin Limited (Ev. 478). This information was given to him by Mr Shierlaw, the underwriter of the issue. Mr Shierlaw was a friend of Mr Hynam (Ev. 479), and their broking firms engaged in reciprocal business. When the offer arrived, it was for 10,000 Samin shares and was addressed to Mr Hynam personally, at his home address.

Among the other recipients of Samin shares in this most popular flotation were Mr Shierlaw's two family companies, N.C.S. Securities Pty Ltd (50,000 shares) and N.C.S. Investments Pty Ltd (50,000 shares), and Mr Shierlaw's broking firm, N.C. Shierlaw & Associates (46,000 shares). Mr T.A. Hutton, chairman of Poseidon, received an allocation of 500 shares for his private investment company, and his wife obtained 1,300 shares. Mr C.F. Wegener, another Poseidon director, obtained 2,000 shares for his family company in which he held a controlling interest. Other subscribers were: Mr B.R. Lewis, his family and family companies, 151,000 shares; and Burrill Investments Pty, 3,000 shares.

28 November: Poseidon's directors sent a letter to shareholders about the legal challenge which had been made to the placement of the 500,000 new shares. The directors sought shareholders' 'ratification and approval' of the placement. Misleading aspects of this letter will be discussed below.

Following the publication of the directors' letter to shareholders, Mr Hynam, still chairman of the Perth Stock Exchange, was active in supporting the actions of the Poseidon directors, and he sought proxy forms from Poseidon shareholders in favour of the directors (Ev. 478 and 494).

19 December: At Poseidon's annual general meeting, which was attended by reporters from the national Press and followed with world-wide interest, the president of the Adelaide Stock Exchange was reported as saying that he was a shareholder in Poseidon and was 'more than happy that the directors had done the right thing' in having arranged the placement of 500,000 new shares on 30 September.

During the meeting, Poseidon's chairman congratulated the geologists on their 'efforts' and said: 'a major mining operation will be possible'. He also invited Mr Jones from Burrill and Associates to address the meeting, but did not require Mr Jones to disclose his and Mr Burrill's very large financial interests in Poseidon shares. In the course of his report, Mr Jones led the public to believe that in only three months the company had established 4 million tons of 'positively indicated' ore reserves and that far greater reserves were likely. We have some comments to make on this subject below.

Poseidon's chairman said, at the conclusion of the meeting: 'I see no reason why any shareholder in Poseidon should not have a wow of a Christmas'.

During the day the price of Poseidon shares rose $30 to close at $130.

31 December: Burrill Investments Pty Ltd sold 2,000 Poseidon shares at prices of $212 and $204 a share through Pring, Dean & Co., a Sydney broker, to realise $406,456.

1970 5 to 7 January: Burrill Investments Pty Ltd sold through Mr Shierlaw's broking firm 2,000 Poseidon shares at prices between $205 and $220 a share, realising $422,111.

Burrill and Associates sold 10,000 North Flinders shares through Mr Shierlaw at prices between $3.70 and $5.00 a share, realising $45,924. (The North Flinders company had been issued with 50,000 Poseidon shares at $5 each in the October placement. Mr Jones was the consulting geologist to North Flinders.)

15 January: Samin shares quoted for the first time on the stock exchanges. The shares, which had been issued at 50 cents each, sold for $20.

At this time, Samin's holding of 200,000 Poseidon shares which it had acquired in the placement at a cost of $1 million had a value based on market prices of $42 million.

19 January: Burrill Investments Pty Ltd sold 3,000 Samin shares through Mr Shierlaw at $19 a share, realising $56,016.

20 January: Burrill and Associates sold 500 Poseidon shares at prices between $196 and $205 through Mr Shierlaw to realise $100,119.

24 February: Burrill Investments Pty Ltd sold 1,292 Poseidon shares through Mr Hynam's broking firm at $230 a share, realising $290,620. Then, between 12 and 16 March, Burrill Investments bought 1,292 shares through Mr Hynam's firm at the lower prices of between $212 and $215 for a cost of $282,920. We will be commenting upon these transactions and their similarity to short sales.

27 February: Burrill Investments Pty Ltd began the sale of 2,000 Poseidon shares through Pring, Dean & Co. at prices ranging from $210 to $255 a share, realising $431,804. With the completion of these sales on 23 March, Burrill Investments Pty had, in the six

months following the discovery, made net sales of 9,000 Poseidon shares for $1,364,293. In the same period, Burrill and Associates had sold 500 Poseidon shares for $100,119. The total cost of these 9,500 shares had been less than $10,000.

19 March: Senator Murphy, in a speech in the Senate, referred to a complaint he had received about insider trading in Poseidon shares and to the failure of either the Perth or Adelaide Stock Exchanges to investigate the matter.

23 March: In reply to Press queries arising from Senator Murphy's speech, Mr Shierlaw issued a statement to all stock exchanges (Ev. 3029).

As we subsequently discovered this statement was misleading as to the extent and timing of the share purchases carried out by Mr Shierlaw as a stockbroker for the geologists and for a trading account of his broking firm. It was also a half-truth to say he was only 'a minor shareholder' in the company, N.C.S. Securities Pty Ltd, for he controlled the company (Ev. 3028). And the announcement did not say that this company had bought large numbers of Poseidon shares on 25 September: it simply referred to purchases 'prior to the discovery'. Mr Shierlaw stated in this announcement that the discovery was on 29 September; as we have already said, the date was, in fact, 24 September.

16 April: Mr Burrill sent a letter to Senator Murphy to say that his speech about the alleged insider trading was 'to say the least, irresponsible and could not be said to be calculated to curtail the many abuses which have crept into stock market transactions' (Committee Document 2-4).

He said that the first purchases of Poseidon shares by Burrill Investments in 1969 were made after the public announcement of 29 April; in fact they were made before it. He said that the drill intersected the massive sulphides on Friday 26 September; in fact, he personally witnessed the intersection on the morning of Wednesday 24 September. (It is significant that, following this event, Mr Burrill had the drill cuttings taken about 200 miles to a Kalgoorlie laboratory, and by the 26th he had received the results of these assay tests. These were tests which the market was never to know had been carried out.) Mr Burrill's letter also failed to mention that Mr Jones, his associate, placed buying orders for Poseidon shares on behalf of Burrill and Associates and Mr Jones on the evening of 24 September and that these were executed on 25 and 26 September.

21 April: Following the appointment of members (16 April) the Senate Select Committee on Securities and Exchange held its first meeting.

28 to 29 July: The Committee heard evidence in Perth on trading in Poseidon shares.

Mr W.R.K. Jones, while giving evidence as a representative of Burrill and Associates (Mr Burrill being out of the country), was asked the question: 'Did you continue during that period [April to 30 September 1969], to which he replied:

About 10 per cent of the number we bought were bought between June and September, I would say, but they were leftovers, if you like, from the original order (Ev. 204).

On several occasions Mr Jones said that the drill had passed through the massive sulphides on 26 September, and he added that there was no way anyone could have known that the drill had s struck massive sulphides before 26 September (Ev. 206).

As we have already said, the day on which the drill struck the massive sulphides was 24 September. Mr Jones' testimony was also misleading as to the timing of the share purchases which Mr Shierlaw had carried out for Burrill and Associates; and in his evidence Mr Jones did not disclose the order for Poseidon shares he had placed for himself, his family and his friends on 24 September. (Mr Jones' subsequent explanations of this misleading evidence are referred to elsewhere in this chapter.)

Mr G.I. Hynam, who at the time of his giving this evidence was still chairman of the Perth Stock Exchange, testified that he did not know of any instance of insider trading on the Perth Exchange. He also said he had never reported an instance of insider trading to the Registrar of Companies. (Ev. 158).

Mr Arthur Charles Manning, Acting Registrar of Companies in Western Australia, gave evidence that there had been no specific complaints of insider trading in recent years. He also said that there had not been an investigation which had revealed an offence (~. 223).

25 September: While giving further evidence to this Committee Mr Hynam said that, as chairman of the Perth Stock Exchange, he had 'been unable to identify' any leakage of information about the Poseidon discovery (Ev. 478). He also said that he did not believe there had been any leakage of information from the directors and geologists (Ev. 479). When asked if there were any basis for thinking that 'there could have been a leak of any real information between 15 and 26 September' he told the Committee: 'No, I have no firm knowledge and I have sought fairly hard to pin it down' (Ev. 500-501).

1972 December:	Documents obtained by the Committee in its investigation of trading records on a different matter contained information casting doubt on the reliability of earlier evidence on trading in Poseidon shares.
1973 January:	In reply to our inquiry, the Adelaide Stock Exchange, which had been the 'home' exchange for Poseidon, informed us that 'no investigations' had been made into the trading in Poseidon shares at the time of the discovery as 'no formal representations were received ... alluding to instances of insider trading in Poseidon shares ...'. In fact, as we will be discussing, on 29 January 1970, a former shareholder in Poseidon did write to the president of the Adelaide Stock Exchange complaining about the trading in Poseidon shares by people 'in the know'. In addition, there had been wide publicity about the allegations of insider trading, and the question had been raised in the Senate.
January to May:	Progressively, as the real story began to unfold, this Committee sent for documents relating to the drilling records of Poseidon's discovery hole, the movement of samples of the drill cuttings, assay analyses and procedures, geological notes, share transactions conducted by various brokers in Perth and Adelaide, contract notes, company memoranda and correspondence and stock exchange reports.

2.28

18 May: After correspondence with the Committee, Mr Jones forwarded a Statutory Declaration which contained some additional information (Ev. 3079).

Again, however, Mr Jones stated that the day of the discovery of the massive sulphides was 26 September 1969, which was untrue. The Declaration also misinformed the Committee as to the day Mr Jones travelled from Perth to Adelaide, and as to the evening on which he authorised Mr Shierlaw to buy Poseidon shares. In addition, the Declaration did not reveal the full extent to which Mr Shierlaw had bought Poseidon shares on Mr Jones' instructions on 25 and 26 September 1969.

14 and 15 June: The Committee returned to Perth to obtain final evidence on the extent and nature of he share-trading which preceded and followed the discovery, and on the geological procedures adopted in the reporting of the Poseidon discovery. It was part of the Committee's objective to give the major participants who had not given evidence to the Committee an opportunity to state any further facts which were relevant to the conclusions to be drawn. In the light of these hearings, the Committee decided to traverse in detail in this Report the sequence of events since early 1969.

2.29

Share-trading Interests of the Consulting Geologists

The Perth company of consulting geologists which Poseidon engaged in early 1969 to assess the seven prospects it had acquired in the Laverton area, Western Australia, was known as Burrill and Associates Pty Ltd. This company had been established by Mr G.H.R. Burrill, who had formerly been working for a Canadian mining group which had sent him to Australia. Mr Burrill had brought into his business another geologist, Mr Walter Royden Keith Jones, and it was Mr Jones' friendship with one of Poseidon's directors which led to their business relationship with Poseidon (Ev. 2991). Messrs Burrill and Jones were then the owners and directors of Burrill and Associates Pty Ltd. Mr Burrill had a degree from London University in mining and mining geology, as well as an associateship with the Royal School of Mining in mining and geology, and Mr Jones had a science degree from the University of Western Australia. After completing the initial assessment of Poseidon's prospects, Burrill and Associates suggested that a major program of exploration should be carried out on two of the prospects. This recommendation was accepted, and the company of Burrill and Associates was instructed to proceed with the program. Mr Burrill said that the instructions came from Mr N.C. Shierlaw and the chairman (Ev. 2992).

Messrs Burrill and Jones did not confine their interest to geological consulting, however, but linked this business to several other activities which brought them into close contact with stockbrokers and the share market. One of their other activities involved the preparation of a monthly bulletin, called 'Mineral Exploration in Western Australia', which provided regular reports on current developments in exploration in the State. The bulletin was distributed by air for a cost of $1,000 a year to about thirty subscribers in Australia and overseas, among whom were about eleven stockbrokers as well as major overseas mining companies and trading groups. The brokers were based in Sydney, Melbourne, Brisbane, Adelaide, Perth and London. These various subscribers could also telephone Mr Burrill and Mr Jones in their office in order to inquire about the significance of the reports made by various exploration companies (Ev. 216). One of the methods by which Mr Burrill and Mr Jones gathered up-to-date information for themselves and their clients was by chartering an aeroplane once a month in order to fly about checking on the drilling operations of various companies and on exploration activity generally (Ev. 214). When referring to these flights, Mr Burrill euphemistically spoke of 'aerial surveillance' (Ev. 2993). However, the clear intention was to obtain knowledge on mineral discoveries before the public generally was informed. Mr Burrill himself said that an essential part of the operation was to look for black sludge coming from drill holes, as this could indicate the presence of mineral sulphides.

In addition to advising stockbrokers and others on what developments were taking place with the exploration of Western Australia, Messrs Burrill and Jones were also actively involved in two proprietary companies which traded in the shares of public companies that were engaged in this exploration. One of these share-trading companies was their own geological consulting business, Burrill and Associates Pty Ltd, and the other company was Burrill Investments Pty Ltd. Mr Burrill said that they had formed the latter company with some of their 'friends' in order to conduct share dealing (Ev. 3017). According to the returns filed with the Companies Registration Office, Perth, two subscriber shares were allotted to Messrs Burrill and Jones in March 1969. Between 18 April and 15 May 1969, a further allotment of 58,748 shares was made, and this was followed by another issue in May 1969 of 20,250 shares. Messrs Burrill and Jones and Mrs

Jones then held a total of 12,250 shares in the company, or about 15 per cent of the capital. One of Mr Jones' family friends who became a significant shareholder between April and May 1969 was Mrs G.I. Hynam, the wife of the chairman of the Perth Stock Exchange (see Committee Document 2-5 for the other allottees of the shares). Burrill Investments Pty Ltd carried out share-trading and investment with about six stockbrokers, among whom were Mr N.C. Shierlaw in Adelaide and Mr G.I. Hynam (trading as S.G. Brearley & Co.) in Perth (Ev. 203). Both Mr Shierlaw and Mr Hynam also received the monthly bulletins from Burrill and Associates. Instead of arranging for Burrill Investments' share dealing to be managed by one or more of the sharebrokers with whom they were associated, Messrs Burrill and Jones apparently preferred to make the decisions themselves (Ev. 3018). This desire to retain control of the day-to-day purchasing appears to have been related to their contemplating a degree of co-ordination in ways which we now describe, between their work as consulting geologists and their interest in share-trading.

Purchases with Inside Information April 1969

The first occasion involving the purchase of Poseidon shares on which the integration of the two sides of the consulting geologists' business took place was in April 1969. This buying was referred to by Mr Burrill in his letter to Senator Murphy of 16 April 1970:

The Board of Poseidon informed shareholders concerning their high regard for the Poseidon property on 29th April, 1969. Burrill Investments bought shares in Poseidon after this statement in their own name and with the approval of the Board of Directors of Poseidon.

(Committee Document 2-4, emphasis by Committee)

This was the same letter in which Mr Burrill remarked that Senator Murphy's speech had been 'to say the least, irresponsible and could not be said to be calculated to curtail the many abuses which have crept into stock market transactions'. Mr Burrill also went on to say that the directors 'have always made every endearour to give any significant information ... at the earliest opportunity'. He said, 'It is essential that information when it is given to shareholders, must be factual'. He then proceeded to set out the 'facts of the Poseidon situation', and it is from this section of the letter that the above quotation has been selected.

Subsequent investigation by this Committee showed, however, that the facts were significantly different from those set out by Mr Burrill.

On 11 April, Burrill and Associates Pty Ltd completed its extensive report to the Poseidon directors on the results of the inspection of the company's properties in the Laverton area (Committee Document 2-1). In respect of the 'Windarra group' of tenements, the consulting geologists reported values in a gossan of 0.50 per cent copper and 0.70 per cent nickel. These tenements were described as 'very encouraging' and 'intensely interesting'. Then, beginning on 24 April, a substantial number of Poseidon shares were purchased, through Mr N.C. Shierlaw, for Burrill Investments Pty Ltd at prices rising from 60 cents to $1.20. On 29 April, the day this order for 10,000 shares was completed, Poseidon made the following announcement to the Adelaide Stock Exchange:

Further to their report of 11th February 1969, the Directors of Poseidon No Liability advise that the Company's full time prospector has pegged further mineral claims on behalf of Poseidon No Liability in the general area of Laverton, Western Australia, making a total of 30 Mineral Claims in several separate groups.

The Company's geologists report that three of the areas namely Group 5 fifteen miles south west of Laverton and also the Windarra Group nine miles north west of Laverton and the Rowena group twenty miles east of Laverton are encouraging and they recommend that further work be done on them.

The Board knows at present of no other reason for the sharp rise in the quotation for the Company's shares.

When Mr Burrill later appeared before the Committee he acknowledged that the buying for Burrill Investments had followed the geological report to the directors but had preceded the directors' announcement to the stock exchanges. The Committee then proceeded to ask why the buying had taken place*.

Senator Rae: The next point I would like to put to you is: Why were you buying during that week preceding the announcement?

Mr Burrill: I have no idea.

Senator Rae: Does it strike you as coincidental that an announcement which was likely to be a bullish factor on the market, as it was at that time, was due to be made, based upon reports from you, and prior to the publication of that, your investment company was buying shares?

Mr Burrill: Looking back in retrospect I think it was a silly time to have done it. I cannot quote back now but quite honestly before we started buying we had to get permission from the Poseidon directors. Whether it was coincidental or whether we deliberately bought before the announcement, I think the timing was damned stupid.

** When Mr Jones first gave evidence in July 1970 to the Committee he was asked the question: 'Had you purchased any shares prior to the publication of that report of 29 April 1969 ?', to which he replied 'No'. He was then asked the question: 'Was there any information which you or your company had which was not available to the general public?' to which he again replied: 'No'. In August 1970, Mr Jones wrote to say that his answer to the first of these questions should have been 'Yes', and 'Yes' now appears in the transcript (Ev. 203). In our view, as we have made clear in the text, the answer to the second question should also be 'Yes'.*

Senator Rae: Would you be prepared to deny that your decision to buy was based upon the information which you personally had?

Mr Burrill: No. We considered the property was a very good one. This is why we went to the directors of Poseidon and asked them if they minded us buying shares.

(Ev. 301 8)

Messrs Burrill and Jones therefore took advantage of an opportunity extending over several weeks to use their special knowledge of Poseidon's prospects obtained as the company's geologists to buy the shares before the rest of the market was informed of their report of 11 April.

In his statement to the stock exchanges of March 1970, Mr Shierlaw confirmed that Messrs Burrill and Jones had sought permission in April 1969 to buy Poseidon shares (Ev. 5029). It will be observed, however, that in the announcement to the stock exchange of 29 April 1969 in which reference was made to the sharp rise in the share price, the directors failed to mention this request to buy shares by Messrs Burrill and Jones. In our view the buying for Burrill Investments Pty Ltd was probably one of the reasons for the rise in the price of Poseidon shares at the time and it would be surprising if Mr Shierlaw had not believed the two events to be related. Mr Burrill's comments on the subject were as follows:

Senator Rae: ... During that week the share price had risen, starting on 24 April a price of 60 cents, and going to a price of 120 cents per share during that week. Would it be unfair if we were to infer that that was related to your knowledge of what was likely to be said, and what was in fact going on so far as Poseidon was concerned?

Mr Burrill: Did the shares move up whilst we were buying or after the announcement?

Senator Rae: Whilst you were buying.

Mr Burrill: Well, I would think probably they would move because of our buying. I have no idea who we bought them through but obviously, if we were buying, some others or whoever we were buying through might have bought them.

(Ev. 3017)

Burrill Investments Pty Ltd bought Poseidon shares on two other occasions during 1969: between 11 and 19 June, 15,900 shares were bought at prices from 70 cents to 90 cents, and between 10 and 29 July, 4,100 shares were bought at 80 cents. ThroughoUt this period the exploration program was being advanced on the Poseidon prospects, and the consulting geologists more than anybody else, except, perhaps, for the directors, would have known how this work was progressing. Once again, although one of the directors, Mr Shierlaw, knew and approved of the geologists' share buying no steps were taken to see that the company's shareholders were advised of this information. There was a further announcement on 24 June concerning the Windarra prospect which reported that 'initial work' had commenced on the exploration program at Windarra. Burrill Investments' buying of 15,900 shares (10,000 of them through Mr Shierlaw) preceded this announcement by about a week. The buying of a further 4,100 shares took place during a period when the magnetometer, geochemical and induced polarisation surveys were being carried out (see Committee Document 2-4). Information about the results of these surveys was not available to the market, but the geologists in charge of the exploration would have known how the work was progressing.

In summary, by the time percussion drilling began on the Poseidon prospect in September 1969, the consulting geologists had bought for Burrill Investments Pty Ltd, their share-trading associate, a total of 50,000 Poseidon shares. In acquiring this holding, Burrill Investments Pty Ltd bought shares from existing shareholders in the company who, at the time they sold their shares, had not been given an opportunity to up-date their assessment of Poseidon's prospects as the result of the work carried out by the geologists. These shareholders who sold their shares also did not know they were selling to a share-trading company associated with and managed by their company's consulting geologists. On the other hand, one of the shareholders' presumed representatives, Mr Shierlaw, did know of the geologists' purchases, and in his capacity as a member of the Adelaide Stock Exchange he acted as the geologists' agent in carrying out much of the buying.

Purchases by the Geologists and a Broker-Director Following the Discovery but Before the Public Announcement

The First Two Holes

Mr Burrill told the Committee that the program for the exploration of Poseidon's Windarra prospect was under his personal supervision and control and that, by September 1969, he had carried out sufficient work to form the view that Poseidon had 'an extremely good prospect' (Ev. 2992 and 3017). Part of his evidence on this point was as follows:

We had trenched the area beforehand, and we had got gossans in our trenching with, I think, values up to about 0.8. There was visible copper oxide on the surface. Now we knew from going over the gossans at Kambalda that this was the type of association that we were looking for. So obviously by the time we finished our trenching, which I think was towards the end of August, in my opinion it was an absolute top prospect. As soon as we got our trenches in, the rating for that prospect went up very much ...

(Ev. 2996)

The first two percussion drill holes on the Windarra prospect were known as PH1 and PH1A. According to the geologists' report to the Poseidon directors of 3 October 1969, PH1 was drilled to 45 feet when it caved in, and PH1A 'passed through oxide zone material and was lost at a depth of 145 feet' (Committee Document 2-2). Records available to the Committee show that during the afternoon of 23 September, samples of the drill cuttings from both holes were despatched by plane to the Kalgoorlie laboratory of Geochemical and Mineralogical Laboratories (W.A.) Pty Ltd (Geomin). In a letter dated 22 September, Mr Burrill instructed Geomin to carry out an analysis by atomic absorption spectrophotometry for nickel and copper of all the samples, but certain samples numbering 3515 to 3529 (which were from hole PH1A) were marked as 'specials' and Mr Burrill said that these 'must be assayed immediately'.

According to the Geomin laboratory, the results of the analysis of the 'specials' were released by telephone to Mrs Burrill in Perth during the morning (at 11.30 a.m.) of 24 September. In respect of three samples, the nickel content was approximately 1 per cent, and in respect of one sample the nickel assay was greater than 1 per cent (see Committee Document 2-3 for details).

When Mr Burrill was giving evidence, he was asked about this early drilling which penetrated to a depth of 'about 140 feet', and he commented as follows:

That hole never got down into sulphide mineralisation, but it got oxides of value which ... are impossible for any geologist to get very interested in. You cannot ever state that because you have values in your oxide that you will have values in your sulphide, unfortunately.

(Ev. 2992)

The formal report of the geologists to Poseidon directors of 3 October 1969 stated that, in respect of hole PH1, the 'average values over [the] first 45' were approximately 1%' and in respect of hole PHIA, the 'average grade of this oxide material was approximately 11~ nickel'.

The Day of the Discovery

The next hole on the Windarra prospect was known as PH2. It was about 20 feet away from hole PH1A and was on a 10. steeper declination. Mr Burrill was personally on site throughout the whole period of the drilling, and he confirmed that the report in the possession of the Committee by Selective Drillers Pty Ltd (the company which had contracted to do the drilling)was a correct record of the progress made with the drilling of this hole (Ev. 2993). This report showed that the percussion drill began working at 12.10 p.m. on Tuesday 25 September 1969, and had reached a depth of 140 feet by 6 p.m. that evening. The next day, Wednesday 24 September, drilling began at 9 a.m. and, with various interruptions, continued until 5.15 p.m., by which time the hole was at a depth of about 185 feet. Correlation of the records of the drillers with other documents in the Committee's possession describing the type of soil and rock through which the drill progressed showed that it was between 145 feet and about 185 feet that the drill passed through the massive sulphides of nickel and copper. Although the drillers' records show that the drill had reached a depth of 140 feet on 23 September, Mr Burrill felt sure that if there had been an indication of the drill touching the massive sulphides that evening, he would have continued drilling (Ev. 2997). He said it was the next morning, shortly after 9 a.m., when the drill struck the massive sulphides. The first indication Mr Burrill had of the presence of sulphides was the change of the coloration of the sludge coming out of the hole, and he described the event in this way:

... When we hit sulphides, and you could see chalcopyrite a copper sulphide in it, I would have been very disappointed and surprised if there had been less than 1 per cent. I have worked for quite a long time for a company called Falconbridge, which is one of the big nickel companies in the world. I have had a reasonable experience with nickel sulphide and I am almost certain I could see nickel sulphides in it. If you can see nickel sulphides you can be pretty certain it is at least three quarters of one per cent but I would not have had an idea whether it was one, two, three, four or five per cent.

Senator Rae: You could see nickel sulphide. Could you see indications of copper?

Mr Burrill: I could see copper sulphide very clearly.

Senator Rae: Is that combination also part of the encouragement?

Mr Burrill: Yes.

Senator Rae: Why it that? Perhaps you could just explain that.

Mr Burrill: All the nickel sulphide mineralisation that had been found up to that point in Western Australia was a copper-nickel sulphide mineralisation. This is the way in which the bulk of the big sulphide deposits in the world occur ...

(Ev. 2996)

The Committee must therefore report that the day of the intersection of the massive sulphides was Wednesday, 24 September 1969. Our inquiries also showed that the only geologist who witnessed this discovery, Mr Burrill, found the event an occasion of great significance. 'As soon as we got 10 feet into that [the massive sulphides]' he said, 'that upgraded the property by a substantial amount' (Ev. 2997). As events unfolded during that day of discovery, Mr Burrill came to believe that he was working on an 'exceptional prospect' (Ev. 3017).

The first announcement to the stock exchanges about this discovery was made on the morning of Monday, 29 September 1969.

The Geologists' Buying

During the afternoon of the day of the discovery, 24 September, Mr Burrill's associate, Mr Jones, travelled from Perth to Adelaide on what he said was 'North Flinders Mines' business, not on Poseidon business at all'. After his arrival, he made a social call on Mr Shierlaw for 'a few beers' (Ev. 3089). According to Mr Jones, this meeting then developed into a discussion of 'the whole Poseidon situation... the sort of thing that might arise from the drilling program and what could happen' (Ev. 3088). Mr Jones told us that he discussed with Mr Shierlaw the buying of further Poseidon shares and that it was decided to buy them for the consulting business, Burrill and Associates Pty Ltd, rather than Burrill Investments Pty Ltd. Mr Jones also authorised Mr Shierlaw to buy shares for his own account, though apparently without specifying the number of shares to be bought (Ev. 3087).

The next day Mr Shierlaw bought 4,000 fully-paid shares for Burrill and Associates and 3,600 shares (fully and partly-paid) for Mr Jones. A further 2,400 shares (fully and partly-paid) were bought for Mr Jones on 26 September. The closing price of Poseidon fully-paid shares on 24 September had been about \$1.12, but on 25th, Burrill and Associates paid up to \$ 1.65 a share.

Mr Shierlaw's Buying

In addition to carrying out Mr Jones' orders, Mr Shierlaw bought a large number of Poseidon shares for two accounts in which he, personally, and his family had a beneficial interest. One of these accounts was operated by the broking firm for

N.C.S. Securities Pty Ltd, a share-trading company in which Mr Shierlaw and his family held the controlling financial interest. Mr Shierlaw described the company as 'belonging to [his] family' (EV. 3030), but in fact a minority share interest was held in the company by the staff of his broking firm. NCS Securities was already a large owner of Poseidon shares, but on 25 September Mr Shierlaw bought a further 11,600 shares for this company.

The other account was known within the firm as the 'London office', and in reply to a question concerning the purpose of this account Mr Shierlaw described it as 'virtually our house account' (Ev. 3037). Mr Shierlaw endeavoured to make a profit in this account through selling the shares to London at a higher price than he had bought them, which is why the account may be regarded as similar to a broker's house-trading account. On 25 September, as the result of many relatively small purchases, he accumulated 10,100 Poseidon shares in this 'London office' account. The Committee has little documentary evidence about the next entry which shows 5,000 of these shares passing out of this account to a London broker on 26 September, but Mr Shierlaw said it was as the result of the London broker buying these shares from Mr Shierlaw during the night of 26 September. On 25 September, a further 1,600 Poseidon shares were bought for the 'London office'. When added to the net buying of 5,100 shares arising from the dealings of the previous day, these additional purchases meant that 6,700 shares were held in the account and owned beneficially by Mr Shierlaw when trading closed for the weekend. Mr Shierlaw said that the additional buying on 26 September was to accumulate further shares in order to offer to London 'a reasonable parcel'. No such offer was made on the night of 26 September, however, as Mr Shierlaw 'was not available' (Ev. 3039).

During 29 September, the day on which the discovery was first announced, and on 30 September, the 'London office' account did not deal in Poseidon shares. Dealings did not begin again until after the assay results of hole PH2 were announced on 1 October, when the shares traded for about $12 each. From that day onwards the 'London office' account became both a large purchaser and a large seller of Poseidon shares. The records show that the value of the transactions ran into millions of dollars, and Mr Shierlaw said that he made substantial profits from these dealings.

Another company for which Mr Shierlaw bought 2,700 Poseidon shares on 25 September and a further 200 shares on 26 September was B.R. Lewis Pty Ltd, which was the family company of Mr B.R. Lewis. In response to our inquiries, Mr Lewis wrote to say that on Tuesday 23 September 1969 while he was discussing with Mr Shierlaw the underwriting of a company called Samin Ltd, he asked whether drilling had begun on Poseidon's Windarra prospect (Committee Document 2-6). He said he was told that drilling had commenced, and that 'considerable buying support for the shares had been forthcoming from Perth, Western Australia, but that no positive reports were available'. Mr Lewis said that 'accordingly' he 'issued a firm instruction for the purchase of 3,000 shares at a limit of not greater than $1.60'. There is a difficulty with this explanation of the events leading to Mr Lewis' purchase in that on 25 September, the Poseidon market was quiet; only 7,800 shares (fully and partly-paid) were reported sold in Adelaide, and the price range was $1.15 to $1.20 a fully-paid share. Moreover, on 24 September, there were only 4,300 shares reported sold in Adelaide, and the price was slightly down. As we shall shortly show in more detail, all the evidence we have seen indicates that it was not until 25 September, the day after the discovery, that there was a sign of 'considerable buying support'. In our view, the buying for B.R. Lewis Pty Ltd on that day provided part of the 'buying support' which led to the spurt in market turnover and the market increase in prices. We discuss below the close associations which were soon to develop between Mr Lewis, Samin Ltd and Poseidon.

Explanations of the Geologists

The first reference by the geologists to the day of the discovery was contained in Mr Burrill's letter to Senator Murphy on 16 April 1970, to which we have already referred (Committee Document 2-4). Another one of the'facts' of 'the Poseidon situation' according to this letter, was that the drill 'intersected massive sulphides' on Friday, 26 September 1969. Mr Burrill also said that Burrill Investments had bought shares 'for the main part ... at least three months before drilling'. As will now be clear, however, this statement by Mr Burrill about the day of the discovery was untrue. His letter was also misleading in making no reference to the Poseidon shares bought by Burrill and Associates and Mr Jones on 25 and 26 September.

When Mr Jones first appeared before the Committee in July 1970, he also said, and repeated several times, that the discovery was on 26 September. For example, in part of his evidence his words were:

The discovery was actually made on 26 September, on the Friday. That was the day they drilled through the massive sulphide.

(Ev. 204)

According to Mr Jones, the heavy market trading in the shares on Thursday, 25 September, could not have been based on knowledge of the discovery. He insisted that 'the absolute earliest' that anyone could have had information which could have given rise to speculation in the shares was 26 September (Ev. 206). In his opinion, the fluctuation in the price of Poseidon shares during the period was due to 'inexperience on the part of investors', 'ill-advised reporting perhaps forced on the company by ... the stock exchange' and 'poor reporting on behalf of the newspapers' (Ev. 205). Mr Jones did subsequently inform the Committee of the buying by Burrill and Associates in September, but when, in his testimony, he was asked about purchases during this period, he said that 'they were leftovers, if you like, from the original order' (Ev. 204). This evidence was not only untrue in respect of the day of the discovery, but misleading about the timing of the buying orders by the geologists. The September purchases were not 'leftovers' of an earlier order; they were the result of a special order placed by Mr Jones himself on the evening of 24 September, the day of the discovery.

On the occasion of Mr Jones' first giving evidence, the following exchange of questions and answers took place between him and Senator Georges concerning the buying of Poseidon shares by the geologists.

Senator Georges: Would you be prepared to give to the Committee the pattern of your purchasing of Poseidon shares, indicating the number and the date of purchases and the price of purchases?

Mr Jones: Yes, we could. That would mean going through our records. I am quite prepared to do it. I do not personally believe that it will achieve any purpose, but you are quite welcome to it.

(Ev. 214)

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Mr Jones: ... we made no attempt at all to purchase them other than in our own name, on the open market and after having advised the directors that we would very much like to take an interest in the company.

Senator Georges: You set up no other company for the purchase of Poseidon shares, did you?

Mr Jones: Not at all. Some of the shares were purchased in the name of Burrill and Associates Pty Ltd. I must make that clear. ... At no time did we buy through nominees.

It will be seen that Mr Jones made no reference to the buying of Poseidon shares for his own account on 25 and 26 September 1969, and in the schedule of purchases he sent to the Committee there was again no reference to his own buying. His subsequent explanation of this omission was that he had appeared on behalf of Burrill and Associates and that 'nobody' asked him 'any questions on a personal basis' (Ev. 3080).

Following a later request by the Committee for the details of any such buying, Mr Jones forwarded a Statutory Declaration in which he gave details of the purchase of 3,000 Poseidon shares for his account and 1,200 for his family on the 25 and 26 September. However, other records available to the Committee showed that a further 1,800 shares had also been bought for his account (by Mr Shierlaw). When he was asked to explain what happened to the other 1,800, he said that he had 'allocated' these at cost to friends, other relatives and acquaintances. He had made this distribution he said, because he could not himself 'afford' the 1,800 shares (Ev. 5090). Yet, Mr Jones also said that the first occasion he knew of the number of shares bought for him by Mr Shierlaw was 1 October, or even later (Ev. 3092). By that time the discovery had been announced and the assay results released. The shares which had cost up to $1.85 each were then selling for over $12, so if Mr Jones could not 'afford' the 1,800 shares he could have sold them immediately and realised a capital profit of about $10 a share, or approximately $18,000 in total. At that point, on the 6,000 shares bought for his account the previous week at a cost of $8,900 (which was not paid to the broker for about a month), he was showing a capital profit of about $60,000.

In his Statutory Declaration (prepared two years after his first evidence) Mr Jones repeated that the discovery had been on 26 September 1969. He also said that the purchases for his own account and for Burrill and Associates followed a meeting with Mr Shierlaw on the evening of 25 September.

At the time of giving authority to Mr N.C. Shierlaw to purchase Poseidon shares in the name of Burrill and Associates on the evening of Thursday, 25 September 1969, I had no reason to believe that a discovery of massive sulphides would occur on the following day, the 26th, or that any such discovery was imminent.

In fact, this Statutory Declaration was misleading about both events. As we have pointed out, the meeting with Mr Shierlaw was on the evening of 24 September, after the discovery that morning, and the buying was carried out the next day, which was the day the shares jumped in price.

When Mr Jones was finally recalled as a witness, he admitted his mistakes about the timing of his meeting with Mr Shierlaw and the day of the discovery. His explanation for his repeated statements that the discovery was on 26th was that he had used the date given by Mr Burrill in his letter to Senator Murphy (Ev. 3081). He also said that he had had 'difficulty in terms of records'. It seemed to the Committee that, in the circumstances, Mr Jones would have checked with Mr Burrill about the discovery date at some stage between September 1969 and May 1973 when he prepared his Statutory Declaration, but he testified that he had never done so.

Senator Rae: ...So that even as recently as 18 May of this year [1973] you were repeating what you had told us earlier and apparently without making any further check about it. Is there any comment that you want to make about that?

Mr Jones: No. I think on one of the occasions I was speaking to Mr Whitbread on the telephone I explained to him, or attempted to, the difficulty in terms of records ...

Senator Rae: Could you have asked Mr Burrill?

Mr Jones: Yes, I could have.

Senator Rae: Did you?

Mr Jones: No.

Senator Rae: At no stage, I assume from what you have told us, from when the accusations and imputations commenced being made in the latter part of 1969, through the period of the Committee's enquiry, when you gave evidence in 1970, and right up until this year when you made this statutory declaration, did you check with Mr Burrill as to what was the date of the most important part of the whole sequence of events, perhaps.

Mr Jones: No. I did not check with Mr Burrill. I had no reason to. Why should I check?

Senator Rae: You told us how difficult it was, you see. I thought if you meant what you said ... that you might have taken the obvious course of asking the person who did know. (Ev. 3085)

This evidence by Mr Jones that he had never checked with Mr Burrill about the timing of the discovery is not easy to reconcile with the testimony given by Mr Burrill. For Mr Burrill said he had 'discussed many times' with his partner, Mr Jones, the purchase of 4,000 Poseidon shares for Burrill and Associates on 25 September 1969. Mr Burrill also recalled having 'a very strong argument with Jones and another director, a man called Lindquist' about this purchase, and he went on to say: 'it was quite obvious when those 4,000 were bought that I knew very accurately that we had a hell of a good property, and I argued, based on that, that we should return them' (Ev. 3018).

Mr Jones told us that he had not had any 'contact with Mr Burrill probably for several days prior to going to Adelaide' on 24 September where he placed buying orders with Mr Shierlaw

(Ev. 3089). He also said that he 'did not know personally until the night of Monday 29 that there was anything of importance at Windarra' (Ev. 3086). His explanation of his buying on 25 and 26 September was as follows:

> ... He [Mr Shierlaw] said something along the lines that he was going to go into the market. I know people find this sort of thing difficult to understand, but this is what happened. He was surprised when I told him that neither Burrill and Associates nor myself had any shares. He said he was going into the market to buy Poseidon shares. He asked whether, if he did this, we would take some of them, I presume to help support him financially to take up sufficient shares to possibly prevent a takeover or whatever he had in mind. The number was not mentioned on that night ...
>
> (Ev.3087)

We discuss below the turnover in the market leading up to this buying on 25 and 26 September, but here we note that we found no evidence of a 'takeover' threat.

Mr Burrill was also called before the Committee at the time of our taking final evidence on the trading in Poseidon shares, and he, too, was asked to explain why he had said (in his letter to Senator Murphy) that the discovery was on 26 September. His only comment was that he 'should have checked' all his records before he wrote the letter (Ev. 3015).

Mr Shierlaw's Explanations

Mr Shierlaw, like Mr Burrill, was prompted to reply to Senator Murphy's speech in the Senate on 19 March 1970, and he released a statement to all stock exchanges setting out what he also called 'the facts'. In commenting upon the geologists' share buying he said:

Burrill and Associates, consulting geologists to Poseidon N.L., stated in April 1969 that the Windarra area had good prospecting potential for nickel, then accordingly sought permission to acquire shares in that company. Their purchases commenced in April 1969, the bulk of which was completed by the 30th June, the minor balance prior to the discovery of nickel and copper sulphides at Windarra on the 29th September 1969.

(Ev.3029)

This explanation suggests that the buying in September was the remaining part - 'the minor balance' - of a much earlier order, which is what Mr Jones also told the Committee when he first appeared as a witness. But, as we have already said, the geologists' buying on 25 and 26 September arose from a meeting between Mr Jones and Mr Shierlaw on the night of 24 September; and the discovery was on the morning of the same day, not on 29 September.

Mr Shierlaw also said in his statement to the stock exchanges that the company, NCS Securities Pty Ltd, in which he was 'a minor shareholder' had purchased Poseidon shares on the market prior to the discovery. A more accurate statement would have been that Mr Shierlaw controlled the company (Ev. 5029). The purchases by NCS Securities also took place after the discovery.

Mr Shierlaw went on to say:

It may be overlooked however, that the stock broking firm of N.C. Shierlaw and Associates of which I am sole proprietor, is required to trade in shares for clients and associates and this must inevitably involve transactions in Poseidon N.L.

The main point to note here is that this public statement did not reveal the substantial buying of Poseidon shares for Mr

Shierlaw's trading account (called a 'London office' account) on 25 and 26 September. Parenthetically it may be recorded that a broker who is also a director of a public company is not 'required to trade' in the shares of that company for his own account. He trades in this way only if he chooses to do so. In our view, this is a highly questionable practice, about which we have more to say.

When Mr Shierlaw was called before the Committee in its final hearings, he was asked why he had said in his statement to the stock exchanges in March 1970 that the purchases of Poseidon shares by the geologists were completed 'prior to the discovery of nickel and copper sulphides ... on the 29th September 1969'. His only explanation was that ~he English is wrong' and that his statement should have read 'prior to the announcement of the discovery' (Ev. 3058).

At this same hearing the Committee was also concerned with finding out from Mr Shierlaw when he believed the discovery had taken place. He testified that right up to the time of his appearance he had not known that the day of the discovery was 24 September 1969. He said that for a period the drillers' records 'were not available', but when they were found he said he had not referred to them. He had apparently been insufficiently interested to check these records of the true sequence of events leading to the discovery notwithstanding the fact that as a director and a sharebroker allegations had been made against him and a court action brought (Ev. 3049-50). We are not able to say whether Mr Shierlaw was aware of Mr Jones' statements to this Committee in public evidence that the discovery was on 26 September, but it is clear from Mr Shierlaw's evidence that, from the time Mr Burrill telephoned him during the night of Friday, 26th, he had known that the discovery was before this date. 'As far as I am aware' he said, 'it [the discovery] was on Thursday morning [25th]' (Ev. 3048).

The Committee also spent considerable time with Mr Shierlaw in discussing his reasons for buying Poseidon shares for himself and his associates on 25 and 26 September. He explained that over the three preceding days he had observed 'substantial increased turnovers' on the stock exchanges for Poseidon shares which had led him to believe that someone was buying 'substantial quantities'. He said that, at the time, he had suspected an 'overseas group' had been buying as part of a market 'raid' in order to acquire the company (Ev. 3044 and 3070). Following inquiries, he had formed the opinion that the major buyer had been operating through a Perth broker, Hartley Poynton & Co. Then, 'first thing' on Thursday morning, 25 September, Mr Shierlaw said he rang his Perth agent and asked him who was buying. He remembered being told: 'The butcher, the baker and the candlestick maker'. In other words, added Mr Shierlaw, 'everyone was buying them'. His testimony continued:

> ... So we decided that, if Perth were buying them and someone who appeared to have a close relationship in proximity to the drilling at Windarra, we thought if it was good enough for them to buy, we should buy ourselves, and I recommended it to various associates ...
>
> (Ev. 3046)

The first part of this explanation was similar to Mr Jones' statements in his Statutory Declaration and subsequent evidence that he had placed buying orders after Mr Shierlaw had told him of the 'larger turnover' and his concern about preventing a takeover. In the process of examining this argument, we collected the reported sales for each exchange in Poseidon shares between Monday, 15 September and Friday, 26 September, and the statistics are set out in the accompanying table. There were about 2 million shares on issue during this period.

Reported Sales of Poseidon Shares
(Fully - and partly-paid shares)

1969 Sept	Sydney	Melbourne	Adelaide	Perth	Total	Price, fully-paid Low High cents
15 Mon	26,700	3,600	24,900	7,600	62,800	90-105
16 Tues	5,900	2,000	13,600	11,170	32,670	105-94
17 Wed	6,500	4,600	6,000	3,500	20,600	94-96
18 Thurs	29,700	6,400	6,900	1,000	44,000	98-105
19 Fri	42,900	19,300	25,250	9,600	97,050	105-115
22 Mon	53,800	18,100	25,800	2,900	100,600	109-128
23 Tues	24,500	3,000	7,800	6,040	41,340	115-120
24 Wed	12,300	7,700	4,300	closed	24,300	110-112
25 Thurs	53,500	closed	48,800	13,500	115,800	115-165
26 Fri	44,200	14,100	40,800	8,000	107,100	140-194

It will be seen that the combined turnover for the three days, Monday, 22nd to Wednesday, 24th, at 166,240 shares, was considerably higher than the turnover of 116,070 shares for the first three days of the preceding week. However, in the speculative share market at the time, when the company was known to be drilling for nickel, it seems doubtful if an objective observer would have regarded these statistics as evidence of a 'raid'. When giving his first evidence to the Committee about the trading in Poseidon shares before the discovery, Mr Jones said that 'lots of people' watched the drill on the property, and that this may have given rise to additional buying pressure.

Senator Little: ... It occurred to me that in most mining or oil companies that I have had reason to watch with interest, if drilling is going on there is always some activity or hardening of the shares brought about by the knowledge that the drilling is taking place.

Mr Jones: That is true ... Certainly the company had announced [on 12 September] ... that drilling was about to commence, or words to that effect. Once the drills got on the property there were lots of people watching it.

Senator Little: People who had been going to buy and who thought they had better hurry up and buy?

Mr Jones: That is right ....

(Ev. 207)

Mr Jones also added that he believed the fluctuations in Poseidon shares at the time the drilling was taking place was 'normal'. He did not mention on this first occasion of his giving evidence the possible 'takeover' he and Mr Shierlaw were to refer to in much later evidence.

Senator Wheeldon: Do I take it from what you said to Senator Little that the fluctuations in Poseidon shares at the time the drilling was taking place would have been no greater than one would normally expect to be associated with drilling ...

Mr Jones: In fact it was well within the normal sort of fluctuation that any drilling brings about ...

(Ev. 207)

At any event, the very marked decline in reported sales between Monday, 22nd, and Wednesday 24th, which were the three days during which Mr Shierlaw said he had observed the 'increased turnovers', would, we should have thought, have cast doubt about the likelihood of a 'raid' continuing. It will also be seen from the table that the highest price at which Poseidon shares sold on 24 September, $1.12, was little different from the high price of $1.15 on 19 September, which was, in turn, for a speculative share at the time, not markedly above the high price of $1.05 on 15 September.

When the Committee pointed out to Mr Shierlaw that his own figures of reported sales between 22nd and 24th (which were not substantially different from those in the table above) were really evidence of declining turnover, he made reference to a rising price range over the three days.

Senator Rae: From the figures that you have given us ... it does seem that the turnover during that week until the Thursday was declining and the price was stable.

Mr Shierlaw: The price range during the first three days rose from $1 to $1.25.

(Ev. 3046)

Examination of stock exchange records showed, however, that there was no increase in prices during the three days. When the point was raised with Mr Shierlaw, he accepted that the range within which the shares traded over the three days did not alter.

The Committee also collected the records of the Perth broking firm, Hartley Poynton & Co., which Mr Shierlaw had believed to be the large buyer during the three days, 22 to 24 September. These showed that the firm had been only a moderate buyer, accounting for about 17 per cent of the reported transactions in Australia on Monday, 22nd, which was the day of the highest turnover. There was no evidence that the firm was operating on behalf of someone concerned with acquiring control of Poseidon.

As Mr Shierlaw's evidence continued, he explained that his concern about a takeover 'raid' has not led directly to his placing buying orders, but had simply started his 'investigations' which had, in turn, led to his finding out that 'a lot of people from Western Australia were buying'. As we have already noted, he obtained this information on Thursday morning, 25th.

Senator Rae: ... First of all you told us that it was because you feared that someone, an overseas company, was buying up with a view to take control of Poseidon?

Mr Shierlaw: That was my first thought, yes.

Senator Rae: And you gave that in explanation of why you were buying on the 25th and the 26th?

Mr Shierlaw: No, I did not give it in explanation.

Senator Rae: I see, Well, that was your first thought.

Mr Shierlaw: That was my first thought.

Senator Rae: So that is why then you made investigations?

Mr Shierlaw: That is correct. That started my investigations.

Senator Rae: When you investigated, you found that it was people from Western Australia, and, I am taking it that we are to assume, people who were likely to have some knowledge of what was going on at Poseidon who were buying, and therefore you thought if those outsiders are interested in buying, we insiders ought to get in on the act.

Mr Shierlaw: I would not say 'insiders getting in on the act'. I see it as: Well, it is good enough for the local indigenes to buy them it is good enough for us.

Senator Rae: And there is no other reason?

Mr Shierlaw: No other reason at all.
(Ev. 3047-48)

And a little later, Mr Shierlaw summarised his reason for buying as follows:

... I am just saying that we moved in on the Thursday because we found out that a lot of people from Western Australia were buying shares. Now, it is as simple as that ...

The difficulty with this explanation is to reconcile it with evidence given by Mr Jones. For, as we have already related, Mr Jones testified that Mr Shierlaw told him at their meeting during the evening of 24 September that 'he was going into the market to buy Poseidon shares'. Mr Jones also said that he had agreed to 'support' Mr Shierlaw 'to possibly prevent a takeover or whatever he had in mind' (Ev. 3087). In other words, according to Mr Jones, his and Mr Shierlaw's decisions to buy Poseidon shares were made on the evening of Wednesday, 24 September, when they were apparently concerned about 'a takeover'; whereas Mr Shierlaw said his decision to buy the shares and recommend them 'to various associates' was made after he learned early on Thursday morning that 'a lot of people from Western Australia were buying shares'.

Answering a Stock Exchange Inquiry

Following the opening of trading on 25 September, the price of the fully-paid Poseidon shares rose rapidly from $1.15 to about $1.60. Whereas only 400 fully-paid and 3,900 partly-paid shares had changed hands in Adelaide on 24 September, on 25 September, 27,700 fully-paid and 21,100 partly-paid shares were sold. The response of the Adelaide Stock Exchange to this sudden buying interest was to inquire of the company if it knew of any reason for the market's behaviour. At 1.15 p.m. on the same day, the Adelaide Exchange received the reply from the directors that 'due to technical difficulties only a limited footage had been drilled' and that 'no assay results are available'. The announcement went on to add: 'Therefore the Board is unable to explain the sharp increase in the price of the shares'.

Now, as we have said, the assay results were 'available' from the 'limited footage', and these had been released to Mrs Burrill during the morning of the previous day. There is no evidence to show, however, that the directors possessed this information at the time. Nevertheless, one of the directors, Mr Shierlaw, had obviously been in a position to explain quite a lot about the market behaviour. Taking the orders he executed as a stockbroker for the accounts in which he was personally interested, as well as those for the Poseidon geologists and for Mr B.R. Lewis, his business associate, the number of shares (fully and partly-paid) Mr Shierlaw bought at the rising prices came to 27,000 which was the equivalent of 55 per cent of the Poseidon shares traded on the Adelaide Exchange that day, and 25 per cent of the total of Poseidon shares reported sold in Australia (a total which would include some double counting). In other words, Mr Shierlaw's own actions as a broker, share trader and investor had had a great deal to do with the rise in price which, as a director, he said he was 'unable to explain'. It will be noted that Mr Shierlaw did not tell the stock exchange of which he was a member what he subsequently told us -- that he believed a market 'raid' had been in process and that there were large purchases by 'someone who appeared to have a close relationship in proximity to the drilling at Windarra'.

Although, as Mr Shierlaw pointed out, the drilling was taking place a long way from Adelaide, the towns and stations in the area could be reached by telephone. Mr Jones told us, for instance, that Mr Burrill made routine calls to his Perth office (Ev. 5089). It seemed to us, therefore, that Mr Shierlaw, as a director of Poseidon, could readily have checked with his company's geologist whether there was some basis for the sudden buying interest which he said had given rise to his own purchases. According to Mr Shierlaw, however, he proceeded with his and the company's geologists' buying orders for two days, 25 and 26 September, and had no contact with Mr Burrill during this period (Ev. 3067).

It will be clear from the foregoing discussions that

Mr Burrill's letter to Senator Murphy following his speech in the Senate on 19 March 1970 was seriously misleading about the timing of the share purchases by Burrill Investments in April 1969 and the date of the discovery in September; it was similarly misleading in omitting any reference to share purchases by Burrill and Associates and Mr Jones on 25 and 26 September 1969 following the discovery but before the public announcement of that event. Mr Shierlaw's public statement to the stock exchanges following Senator Murphy's speech was also misleading about the date of the discovery and the extent and timing of the share purchases he carried out for the geologists and accounts in which he was interested. In addition, many of Mr Jones' statements and answers to questions by this Committee on the same matters were found, upon closer examination, to be untrue. Although Mr Shierlaw and Mr Jones denied that they had had any knowledge of the discovery when they bought shares on 25 and 26 September, we have found the explanations of their joint action unconvincing and inconsistent with the other available evidence. It is hard to escape the conclusion that they did buy Poseidon shares at a time when they had material information about the company's mineral prospect which had not been released to shareholders and the market. As far as the geologists were concerned, this was a pattern of behaviour repeated throughout the period April to September 1969.

Mr Biggs' Punt

The pastoral lease on which the Poseidon nickel prospect was located was owned by Mr Keith Bigcs of Leonora, a prospector and company director. Anticipatory buying of Poseidon shares in the weeks and particularly the last few days before the spectacular public announcement made Mr Biggs one of the great beneficiaries from the boom. The 24,100 shares which he bought soon before the announcement at a cost of about $30,000 were to have a market value of about $850,000 by the end of the month following the purchases. The Committee invited Mr Biggs to give evidence regarding the motives for his share purchases.

In his testimony, Mr Biggs explained how he had been most active in pegging claims during the mineral boom. He said he had numerous partners in this activity, and had negotiated many joint-ventures with various mineral exploration and mining companies, frequently in exchange for vendor shares. Combined with his prospecting interests, Mr Biggs had run a network of accounts and companies for share-trading and investment purposes. (Several of these had, for tax reasons, been set up with overseas shareholders and locations). One of the companies, Granby Pty Ltd, was acquired by Mr Biggs in August 1969, and on 29 August 1969 it carried out its first transaction by placing a buying order for Poseidon shares with Perth stockbroker, Hartley Poynton & Co. Between 29 August and 16 September, 9,100 shares were bought at prices between 72 cents and 90 cents a share. This was a substantial order compared with Mr Biggs' previous trading, but it was soon to be exceeded by a much bigger transaction.

On 25 September 1969, Hartley Poynton bought 15,000 Poseidon shares for Granby Pty Ltd. Mr Biggs placed this order during the afternoon of 24 September, only several hours after the discovery, and although the highest price for Poseidon shares on 24 September was about $1.12, his instruction was that the shares were to be bought at prices up to $1.50 a share (Ev. 3097). Mr Biggs recalled his broker suggesting that this was a 'big punt', but he said he had replied: 'A punt's a punt, and if it does not come off I go broke' (Ev. 3098).

Mr Biggs told the Committee that Mr Burrill did 'quite a bit of work' for him, following the Poseidon discovery, and that he and Mr Burrill used to exchange mining and share market information. On one occasion they also engaged in share-trading together. However, Mr Biggs said he had not known Mr Burrill 'very well' before the discovery, though Mr Burrill had done some work for him earlier in September 1969 (Ev. 3098-99). Documents in the Committee's possession showed that when Mr Burrill returned to Perth after the discovery he took with him rocks from Mr Biggs for analysis at the same laboratory as some of the Poseidon cuttings were analysed. Mr Burrill and Mr Biggs were both questioned about the timing of the discussions which had led to this arrangement.

Mr Biggs thought that the rocks were 'probably' collected by Mr Burrill some weeks before he took them to Perth. He said that apart from this arrangement he had 'no other association at all' with Mr Burrill up to 25 September (Ev. 3099); he added that he had not spoken to him between a day well before 24th and over a fortnight later (Ev. 3105).

Mr Burrill, on the other hand, began by saying he had had no contact with Mr Biggs between 24 and 29 September, but ended up by saying 'it is quite obvious' that he had spoken with him between the morning of 24th and the time when he left to return to Perth.

Senator Rae: Did you have any discussion with Mr Biggs from about the time of the intersection on the 24th until you left the site to return to Perth?

Mr Burrill: No.

(Ev. 3019)

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Senator Rae: Do you recall him giving to you some rocks, some gossans, at that time to take in and you, in fact, taking them in to Sheen Laboratories for analysis along with the ones that you took from the Poseidon PH2 Hole?

Mr Burrill: It is possible, I used to take the stuff in for him all the time. I do not specifically remember that, but it is quite possible I did.

Senator Rae: It is quite possible that you had some discussion with Mr Biggs between the morning of the 24th and when you left the site to return to Perth?

Mr Burrill: If I had some samples from him it is quite obvious I did, yes.

(Ev. 3019)

Mr Burrill also said that Mr Biggs' manager used to move about 'picking up gossaris or supposed gossaris' which he brought to Mr Burrill to have assayed or analysed. This manager used 'to come around relatively regularly' Mr Burrill commented, and though he did not remember him being there he thought it was 'possible' that the manager was on the site on 24 or 25 September.

When Mr Biggs was asked to explain why he had bought Poseidon shares, he described hoe he had followed the exploration work on his pastoral property. He said it was 'common knowledge in the district of Laverton and Leonora' that the company regarded the prospect 'very highly'. He added that the 'value of the gossans' exposed by the bulldozing before drilling began had also been 'common knowledge'. It was on the basis of this information that he had bought the 9,100 shares between 29 August and 16 September (Ev. 3096-97).

The explanation for his next, and much larger, order placed during the afternoon of Wednesday 24 September was that he had heard that the drill had struck nickel sulphides. He said 'there were all sorts of rumours ... one strong rumour - you may well laugh at me - was that the drillers had been seen in Laverton with sulphides on their boots and things'. He also said that 'they had been seen ringing up' (Ev. 3097). Following his telephone call to his Perth broker, he was 'having a beer' when he heard further rumours. In reply to the Committee's request to elaborate on what he had heard, he said:

> ... there was just talk in the bar that they had found some sulphides in Laverton - just talk -and there was so much talk going on in the week before and during that time that I just cannot recollect everything that happened, everything that was said, or who said it. I have not a clue.
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> (Ev. 3097)

Based on this and other evidence we received, it is our view that the Poseidon company had inadequate security arrangements for preventing the dissemination of information about the progress with the drilling before the market was informed. Whether by receiving information directly about the drilling, or by observation, people were able to spread rumours which had some foundation, and these quickly gained currency so that people in the area were able to take advantage of them. This points up the need for a close examination of the circumstances in which there should be prohibitions on the dealings in shares by tippees and others before material information has been made public.

Share Placements made with Inside Information Secret Assay Reports from Kalgoorlie

On the same day as the massive sulphides were intersected, Wednesday, 24 September, the drill penetrated to a depth of about 185 feet. Drilling continued over the next two days, and the hole (PH2) was completed at a depth of 252 feet on Friday, 26 September. Before the completion of the hole, however, Mr Burrill arranged for the transport of samples from the first 185 feet of drill cuttings, which included the section containing the massive sulphides, to the Geomin laboratory in Kalgoorlie, about 200 miles away. Geomin received the samples on 25 September, with instructions to carry out an urgent analysis for copper and nickel by atomic absorption spectrophotometry (AAS). The results were to be ready the next morning, Friday, 26 September.

The particular advantage of this Geomin AAS test was that it could be done speedily. The disadvantage was that it would not give reliable readings for nickel content above one per cent. In circumstances where the readings were above this figure, it was therefore the laboratory's policy to withhold the precise details and simply report that the samples had assayed greater than one per cent nickel. Geomin had a laboratory in Perth which was equipped to carry out what were called the 'chemical assays' necessary to give the more exact readings over one per cent nickel.

On the Friday, Mr Burrill learned that, of the 36 samples he had sent in from hole PH2, 30 samples, which included all those covering the 40 feet of massive sulphides, had assayed greater than one per cent nickel. The copper readings were also highly encouraging, so that Mr Burrill was confirmed in his belief that they had discovered an exceptionally promising deposit of nickel and copper sulphides. After receiving these results, Mr Burrill attempted to telephone the information through to Mr Shierlaw, but could only reach Mrs Shierlaw. According to Mr Shierlaw, later that night, his wife told him that Mr Burrill called and was 'highly excited'. Mr Shierlaw then returned Mr Burrill's call and spoke to him in Laverton. Mr Burrill said that when the directors wished to contact him at the drill site, 'they used to contact the Postmaster at Laverton - a man called Don Leahy' who would then drive out to his caravan, about 18 miles from Laverton (Ev. 3002). On the night of 26 September, however, Mr Burrill said he had waited around the Laverton Post Office until Mr Shierlaw had returned his call (Ev. 3001).

Mr Burrill admitted that he knew that further chemical tests had to be completed by Geomin in its Perth laboratory before the accurate assays of the samples with nickel content above one per cent would be available, but he decided not to wait for these.

During the weekend, or on Monday, 29 September, he telephoned the employee of the Kalgoorlie laboratory who had given him the results of the AAS tests and asked for the assay readings for the samples from hole PH2 containing more than one per cent nickel. Both Mr Burrill and the employee knew it was against the rules of the Geomin company to release these readings, but the information was, as the result of Mr Burrill's pressing for it, conveyed to him. The results were stunning: the nickel content of the sulphide samples ranged between 2 and 5 per cent, and again the copper content was most favourable. We refer to this release of information from the Geomin laboratory as its 'unofficial report'.

On Monday morning, 29 September, the Poseidon directors wrote to the Adelaide Stock Exchange to say that the percussion drill had encountered nickel and copper sulphides and that 'the assays of the samples will be published as soon as possible'. In effect, with this announcement the directors were informing the market for the first time of the discovery which Mr Burrill had observed on 24 September. But the announcement was written in such a way that the market's knowledge of what had happened was still nothing like as informed as that of the directors and Mr Burrill. The impression given was that assay tests had still to be completed, which was true, for Geomin and another laboratory had still to carry out certain analytical work. But it was also true that some valuable assay tests had already been completed, and the announcement did not say this.

It was suggested to us that the directors were acting cautiously in not referring to the assays at this stage, especially as the assays resulting from the AAS tests were known to be only partially reliable. While we recognise that responsible directors might, in such circumstances, have preferred to wait until further and more accurate tests had been completed, in

Poseidon's case, we found this argument unconvincing. For while the directors were withholding knowledge of the first assay results from the market, they, and the geologists, took action to issue large quantities of new Poseidon shares to companies with which they were closely associated. In addition, when the directors and geologists did come to release assays to the market after arranging these placements, the assays they released were not those obtained from the more accurate tests, for these had not been completed, but those derived by Geomin from the only partially reliable AAS tests.

At this stage we should mention that some investors other than the directors and geologists pretty clearly did learn extremely quickly of the assay tests of the Kalgoorlie laboratory, or heard rumours of the results; for during the course of trading on the Monday, the price of Poseidon shares rose to $5.80. The next morning, Tuesday, 30 September, the financial editor of the West Australian reported:

... yesterday the rumours became a high-pitched screech that nickel of a richness and volume equal to, if not surpassing, anything yet found in Western Australia has been found ...

This was the occasion on which the West Australian made the first of its calls for a stock exchange inquiry - an inquiry which was never carried out.

Issuing New Shares to Directors' Associates

In the next Poseidon announcement to the stock exchanges on Wednesday morning, 1 October, in which assay results were given, it was stated that 500,000 new shares had been placed with 'other mining development interests' to raise $2,800,000 to finance exploration and the 'anticipated development program'. In other words, before this Wednesday morning when the nickel and copper assays of samples from hole PH2 were announced for the first time, the directors had had reason to anticipate the need for large amounts of capital for the 'development' of the nickel and copper deposit.

Three of these other mining 'interests' turned out to be North Flinders Mines N.L. (100,000 shares), Nobelex N.L. (50,000 shares) and Australian Development N.L. (50,000 shares), each of which paid a price of $6 a share for the new scrip. Investigation by the Committee showed that these companies were, in a variety of ways, closely associated with one or more directors of Poseidon. North Flinders Mines had been formed in April 1969 and floated in June 1969 with Mr Shierlaw's broking firm as underwriter in combination with Melbourne brokers, Guest and Bell. Three Poseidon directors, Messrs Shierlaw, T.A. Hutton and C.F. Wegener were also directors of North Flinders, and in a letter to shareholders of Poseidon on 28 November 1969 (referred to below) they described themselves as 'substantial' shareholders in North Flinders. Poseidon was also a large holder of options in North Flinders. The total cost of the Poseidon shares bought by North Flinders in the placement was $600,000, which was a large sum in relation to the $1.3 million which had been raised in the public float.

Nobelex was arc. other new company which had been recently floated to the public. Its incorporation was in March 1969, and Mr Shierlaw underwrote the public issue in May 1969. Messrs Shierlaw, Hutton and Wegener were also substantial shareholders in the company. In relation to the amount raised in the public issue of about $1 million, the sum of $300,000 paid for the shares in the Poseidon placement was considerable.

In the case of Australian Development, Mr Shierlaw was again a director and a substantial shareholder, and his broking firm had acted as underwriter of a new issue of shares in March 1969. Australian Development had been one of the 'sponsors' of the Nobelex issue, and was a large holder of vendor shares in that company.

Another large purchaser of the shares from the Poseidon placement was Samin (200,000 shares), and some of the circumstances in which this company was formed and floated on the public market following the acceptance of these shares should be especially noted. At the time the Poseidon placement was ar~ounced, on 1 October, Samin was not incorporated, though there had been discussions between Mr B.R. Lewis and Mr Shierlaw over its formation and flotation. We have already noted how, in the course of one discussion, Mr Lewis had placed with Mr Shierlaw buying orders for Poseidon shares which were executed on 25 and 26 September. Samin's incorporation was on 6 October, and on 10 October it received its Cervificate of Entitlement to Commence Business and Exercise Borrowing Powers. The prospectus for the flotation two months later revealed these facts, and it also disclosed that the underwriting agreement with Mr Shierlaw was not signed until 22 October. At that stage, Samin's issued and paid up capital was only $250 (excluding 200,000 shares issued to Poseidon at 50 cents each as part of the deal with that company). How, then, was it in a position to pay Poseidon $1,000,000 before 1 October in order to buy 200,000 Poseidon shares at $5 each? This is a curious question which we have not had time to explore fully. But, once again, part of the answer is to be found in the prospectus, which was released well after the events had taken place. Samin borrowed the entire $1,000,000 from a bank, and the capital of approximately $1.65 million raised from the public was used largely to repay the loan. Presumably the huge increase in the price of Poseidon shares following the announcement of 1 October (discussed below) gave great scope for using the placement scrip as collateral for borrowing. But this, of course, is to look at the transaction with hindsight, it does not necessarily explain how Samin proposed to finance its purchase before it knew of the impact of the announcement on the market, nor does it explain why Poseidon directors believed Samin would be in a position to provide such a large sum in cash. The close relationship between Poseidon and Samin was further cemented by Samin agreeing to provide certain 'technical services' to Poseidon, and Mr B.R. Lewis became a director of Poseidon in December 1969.

The large equity interest of Samin in Poseidon was to prove of immense benefit to that company and to its promoters and subscribers at the time of the flotation in December 1969, for when Samin's shares were first quoted on the stock exchange they sold at $20 each, which provided a handsome capital profit on the issue price of 50 cents a share. Among the subscribers were Mr Shierlaw's family companies (100,000 shares); Mr Shierlaw's broking firm, of which he was sole proprietor (46,000 shares); Mr B.R. Lewis, his family and family companies (151,000 shares); Burrill Investments (3,000 shares); the wife of Mr T.A. Hutton and Mr Hutton's private investment company (1,800 shares); Mr C.F. Wegener's family company (2,000 shares); and Mr Hynam, his family and family companies (6,000 shares). Mr Shierlaw also received $72,488 from the proceeds of the flotation for his underwriting services.

Immediately after the Poseidon announcement to the stock exchanges of 1 October, the Poseidon shares increased in price to $12, rising further to $17.70 the next day. Within twenty-four hours, therefore, the new scrip issued in the placement was valued in the market at twice the price at which it had been issued. Overnight, this placement had greatly enriched four companies in which some of the Poseidon directors were substantial shareholders or with which they were associated in other ways.

Mr Shierlaw also had a further interest in these placement transactions, for his broking firm acted as the broker in negotiating the placements (Ev. 3065).

When Mr Shierlaw was being questioned about the timing of the arrangements for the placements he said:

I would like to make it very clear here that the placement was made before any assay results were available. Therefore, one did not have a clue as to what the assay results would be at the time the placement was made. The decision was made that the placement be taken on the Monday, after the public announcement had been made, of the discovery of nickel and copper sulphides at Windarra on the Monday. The placement was arranged on the Monday afternoon, however the price was to be determined at the close of marker on the following day. The market closed on the following day some three hours before Mr Burrill arrived with the assay results. So there was no way in the world this placement was made with knowledge of the assay results.

(Ev. 3061)

Now it is unclear from the evidence when Mr Burrill passed the information on to Mr Shierlaw about the high readings of the nickel assays above 1 per cent released unofficially by the Geomin employee. Mr Burrill said that he 'may have' told Mr Shierlaw of this information before Tuesday evening, 50 September, but he did not think so (Ev. 5007). Mr Shierlaw, on the other hand, said he did not learn from Mr Burrill of this unofficial report until about 6.50p.m. (Adelaide time) on 50 September (Ev. 5051 and 5062-65). The fact that the market behaved in the way it did, and that the Press should have at once, on Tuesday morning, 50 September, reported rumours at a 'high pitched screech' of nickel of extraordinary richness, suggests that the information did not rest only with Mr Burrill and the Geomin laboratory.

However, it is an undisputed fact that the official assay report of the samples from hole PH2 was released to Mr Burrill by Geomin on Friday, 26 September, and that, by the early hours of Saturday, 27 September, Mr Shierlaw had been told of this report. This was two days before the decision was taken to place new shares. It was four days before the release of any assay results to the market. Mr Shierlaw was being disingenuous in saying that 'the placement was made before any assay results were available' and that 'one did not have a clue as to what the assay results would be ...'.

When the foregoing facts were put to Mr Shierlaw, he pointed out that the public announcement of Monday, 29 September preceded the placements. He also implied that, at any event, the Geomin AAS tests had not really given the directors knowledge of much significance.

Senator Rue: ... By Saturday morning you, Mr Burrill, the other directors of Poseidon knew that assay results were in excess of one per cent and were interesting and were exciting, or whatever other words may have been used.

Mr Shierlaw: Yes.

Senator Rue: You say that it was on the Monday that the placement was arranged.

Mr Shierlaw: That is so.

Senator Rue: After you had knowledge?

Mr Shierlaw: And after we had made a public announcement.

Senator Rue: What was the nature of the public announcement?

Mr Shierlaw: That Poseidon Ltd had intersected nickel copper sulphide.

Senator Rae: Which could mean anything, could it not? It does not mean that there is a section 40 ft deep of more than 1 per cent?

Mr Shierlaw: No one had a clue. I certainly did not have a clue, and neither did any of the directors what the length was or what the assays were or anything.

(Ev. 3062)

By contrast, Mr Burrill in his evidence on several occasions referred to the excitment with which he learned the results of Geomin's AAS tests. For example, when the Committee suggested that he would have been 'quite elated' with the results, he replied: 'That's putting it mildly' (Ev. 3001).

In our view, there can be no doubt that when Mr Shierlaw heard the assay results of the cuttings from hole PH2 were in excess of one per cent he had information of great value concerning the worth of the deposit which was not conveyed in the public announcement of 29 September. We believe that improper advantage was taken of this knowledge in arranging the placement to the companies associated with three of the Poseidon directors, to the clear advantage of those directors, their families and associates.

Placements Through the Geologists

Whereas it was the Poseidon directors, through Mr Shierlaw, who decided where 400,000 of the 500,000 new Poseidon shares would be placed, with the other 100,000 shares the decision was left to Poseidon's consulting geologists. Mr Burrill told us that during the evening of Tuesday, 30 September, while at a meeting of Poseidon's directors in Adelaide, he telephoned two of his overseas contacts and offered each of them a parcel of 50,000 new shares at a price of $6 a share. One of the people he spoke to was the chairman of the large Canadian mining group, Conwest, which had earlier sent Mr Burrill to Australia on a three-year contract to set up an exploration program. Mr Burrill had subsequently set up his own consulting business, but he said he knew Conwest 'had expressed tremendous interest in the Windarra area' (Ev. 3013). Our investigations also revealed that, between 21 August and 19 September 1969, Burrill and Associates were associated with Conwest Exploration Co. Ltd, Canada, in buying 2,000 Poseidon shares in the Australian market. According to the brokers' records, the shares were bought for 'Burrill and Associates No.2 Account', but Mr Burrill told us in writing that the shares were bought 'on behalf' of Conwest Exploration, and that the order was placed by Conwest's managing director. Mr Jones also told us (in July 1970) that he and Mr Burrill had 'some small association' with Conwest (Aust) N.L. (Ev. 199).

Mr Burrill's other overseas call was to London stockbrokers, James Capel and Co., who ran a fund called First Investors Mining Petroleum Fund. Mr Burrill said he was on the management committee of this fund, together with executives of various international mining companies:

... two people from South Africa; the chairman of the Union Corporation was on it; the chairman of Patino; two of the big French mining houses - people like Union Miniere; Falconbridge's chairman was on it and some of the big banks.

(Ev. 3013)

Although this fund was managed by London brokers, it was located in Switzerland, and its meetings were normally held in Toronto or Geneva. Mr Burrill said he had intended that half the 50,000 shares being offered to Capels should be passed on to the fund, and the other half to a London merchant bank, Hambros, whose chairman was also the chairman of the fund just mentioned. Mr Burrill went on to say, however, that contrary to his stated intention, Hambros and First Investors Mining Petroleum Fund received only a part of the placement and the rest of the shares were spread among the broker's clients.

When the Committee asked Far Burrill if he explained to these overseas people why it would be a good idea for them to accept the new shares, he replied:

I did not have to. If I, in my position, said that I recommended that they take it, they would take it.

(Ev. 3014)

Just which of his various 'positions' Mr Burrill had in mind is not clear, but, of course, one of them included being Poseidon's geologist, and he said his overseas contacts knew of this appointment. On 30 September, therefore, Mr Burrill was in a remarkably favourable 'position' to recommend the purchase of Poseidon shares, for at that time he possessed the knowledge of the extraordinary high assay results of the intersection of 40 feet of massive sulphides which were to be released to the market the next morning. In our opinion, he used the confidential knowledge he had as Poseidon's geologist to benefit financially those with whom he was or had been associated in another capacity.

The Misleading 'Letter to Shareholders'

Understandably, with the announcement of the details of the share placement in 1969, a considerable public controversy arose, and one investment group began court action to try to have the issues set aside. It was in connection with this action that the Poseidon directors, on 28 November 1969, circulated a 'Letter to Shareholders' in which they said:

An Application for an Injunction came on for hearing before a Judge in chambers on 7th November when the following order was made:

"Application stood over to 31st December to enable directors of the defendent Poseidon No Liability if so advised to convene a meeting to consider such resolution as may be submitted to it".

The directors went on to explain the circumstances in which the placements had been made; they also gave notice that they would seek from shareholders 'ratification and approval' of the issue at the forthcoming annual general meeting. Extracts from their explanation follow:

... Your directors saw in the favourable climate produced by the announcement on Monday, 29 September the opportunity to obtain the funds ... An assay report was expected in some 48 hours time. If this should prove to be unfavourable the opportunity for obtaining funds might be lost. It was recognised of course that a favourable assay report might have the effect of increasing the market price of the shares, but the importance of obtaining funds to secure the future of the company irrespective of the assay report was regarded as paramount. This involved negotiating with companies which were prepared to share the risk moreover of an unfavourable assay report ... The arrangements were completed before 5 p.m. on Tuesday the 30th September. The arrangements were deliberately completed before the assay reports were known ... On the evening of the 30th September, after the conclusion of the above agreements, the Assay Report on No.2 hole was received in Adelaide ...

Having already kept their shareholders and the stock exchanges ignorant of the Kalgoorlie assay tests, the directors had apparently decided to continue doing so, for the clear implication of the letter was that the directors did not have knowledge of any assay results before the placement of the new shares was completed on the evening of 50 September. As we have seen, however, important assay results had been known to the directors well before they set about arranging the placements to their and the geologists' 'contacts' and associates.

Stock Exchange Support for the Placements

At the annual general meeting at which shareholders were called upon to ratify the placement, the directors were well supported. Two people reported to have spoken in favour of the placement were Mr A.K. Sangster, Q.C., and Mr D.I. Macarthur, the president of the Adelaide Stock Exchange. Mr Sangster was reported as telling the meeting that he was attending both as a proxy holder and at the request of four of the companies to which the shares had been allotted. He was also reported as saying that 'he felt many shareholders were not acquainted with the background of the allotments' and that the placements were made at the stage when 'the assay results were not known' (Sydney Morning Herald, 20 December 1969).

Mr Macarthur went rather further in his support of the directors. He was reported as saying that he and his brothers had been interested in the company from the start, and that he was very surprised when he heard that the allotments had been made. But he was then quoted as saying: 'However, when I found out the circumstances of the allotments I was more than happy that the directors had done the right thing'. With support for the placements coming from this quarter, it is perhaps not surprising that public criticism was quietened and the critics outnumbered.

In his evidence to the Committee, Mr Shierlaw confirmed that the president of the Adelaide Stock Exchange had been a shareholder at the time of Poseidon's meeting, and that the report of his statements to the meeting was correct. Mr Shierlaw also said that neither the president nor the stock exchange committee inquired of him about the placement, but inquiries had been made of the company. When asked what these inquiries were, Mr Shierlaw replied: 'I think they just wanted to know the circumstances of the placement. I cannot recall the details' (Ev. 3065).

Whatever was involved in its inquiries, the Adelaide Exchange did not bring to light the information that a valuable assay report of the cuttings from the discovery hole had been available before the placements were negotiated, and that the directors' letter to shareholders was misleading in not making reference to this assay report. As we shall shortly show, this was not the only stock exchange which, through its president or chairman, was to support the Poseidon directors after having failed to carry out adequate investigations in fulfilment of its regulatory responsibilities.

Firing the Boom

As the public announcement of the Poseidon directors to the Adelaide Stock Exchange of Wednesday, 1 October 1969, was of singular importance in the build-up of Australia's most recent mineral exploration and share boom, we quote it in full:

Further to the report of the recovery of nickel and copper sulphides on 29th September, the Directors of Poseidon N.L. announce that the assays received to date of the first completed drill hole PH2 at Windarra, W.A. are as follows:

From-to in feet	Length in feet	Ni%	Cu%	Type of ore
0-25	25	0.40	0.10	leached Oxide
25-115	90	1.53	0.25	Oxide
115-145	30	1.60	0.40	disseminated sulphides
145-185	40	3.56	0.55	Massive sulphides

The consulting Geologists, Burrill & Associates Pty Ltd quote that the mineralised zone has an indicated length of one thousand (1000) feet and minimum of sixty five (65) feet.

These estimates are based on results obtained in this drill hole, together with trenching across the zone and detailed Induced Polarisation surveys. This zone has been named the Shirley Shoot after the prospector who discovered it.

They also state that four (4) additional anomalous areas in a similar geological environment have been indicated on the property.

The directors have authorised a full programme of percussion drilling to outline the potential ore zones followed at a later stage by deeper diamond drilling.

Further drill hole results will be announced in groups of holes instead of on a hole to hole basis.

The Company has arranged a placement of 500,000 shares to other mining interests, totalling $2,800,000 to finance this exploration and anticipated development programme.

It will be seen that the assay results released in this statement were given with high precision. For example, the nickel content for the 40 feet of massive sulphides was said to have been calculated to six ten-thousandths of the total mass, giving an assay of 5.56 per cent.

With the unfolding of the Committee's inquiry into the circumstances in which these Poseidon announcements were made, we came to question whether there was ever an adequate scientific basis for this announcement which was to have such a dramatic effect upon the share market. While it was clear that some important assay results were available before the announcement, for several reasons it seemed that these could hardly have been the source of the precise details given to the stock exchanges. First, the results of the AAS tests on the cuttings from hole PH2 which were released officially by the Geomin laboratory in Kalgoorlie on 26 September did not give any readings for nickel content above I per cent. Secondly, the readings above 1 per cent which were given by an employee of that laboratory to Mr Burrill were released against the rules of the laboratory, were apparently never confirmed in writing, were known to be inaccurate, and were, at any event, according to the general manager of the laboratory, rounded down to the nearest whole number (Ev. 3132). Mr Burrill did instruct this laboratory to carry out a more accurate chemical analysis in its Perth laboratory, but these results were not available until two days after the public announcement of 1 October. Documents obtained by the Committee also showed that, on 29 September, Mr Burrill instructed another Perth laboratory, Sheen Laboratories Pty Ltd, to carry out an assay of 10 samples, each covering a 5 foot section of the cuttings from the discovery hole, and these results were available on 50 September, late in the afternoon. However, only one of these samples was from the 40 foot intersection of the massive sulphides; it could not have been the basis for a precise nickel and copper assay over the entire intersection.

The first witness we questioned about these matters was Mr Burrill, who had been mainly responsible for the calculation of the assays announced to the market. He confirmed that the only assay results of the cuttings from the discovery hole which were available to him before the announcement were those which had been officially released by Geomin on 26 September, those he had obtained unofficially from the Geomin employee, and those completed by the Sheen laboratory on 30 September. He also acknowledged that the samples assayed by Sheen included only one 5 foot sample from the massive sulphides.

Senator Rae: Were there any other results which were available to you by the time that you prepared this report to the stock exchange?

Mr Burrill: No, I would have thought we sent more to Sheen, but obviously we did not.

Senator Rae: So when you calcula~ed your 3.56 per cent for the purposes of the report to the stock exchange dated 1 October 1969 the only information which you could have calculated that on would be the telephoned information of the approximate percentages given to you by Geomin at Kalgoorlie.

Mr Burrill: That is right.

(Ev. 3006-7)

Having established the basic source of the information, the Committee was concerned to know how the precise assays had been calculated for release to the share market.

Senator Rae: But is not the AAS test result something which is regarded by analysts and by geologists as being unreliable over 1 per cent?

Mr Burrill: It is not accurate over 1 per cent, and the higher it gets the less accurate it gets.

Senator Rae: When you received the figures - we believe it was Mrs Vertes of Geomin - did she give those to you in whole percents or in percents and part percents? In other words did she give you 3 per cent, 4 per cent, 2 per cent or whatever it may be, or did she give you 3.25 or 4.26 or whatever it may be?

Mr Burrill: I would be most surprised if she gave them as per cents. She would probably average them to half a per cent or possibly a quarter per cent.

Senator Rae: If she says that she gave them to you to the round per cent lower would you be prepared to dispute that?

Mr Burrill: No.

Senator Rae: Then it becomes all the more curious as to how you work out a figure of 5.56 per cent nickel for the purposes of the stock exchange report if all you had at that time was a set of figures given to you over the telephone by Mrs Vertes rounded off to the nearest lower per cent.

Mr Burrill: It does. What were the figures?

Senator Rae: Have you any records which would help you in saying what they were, because I would like you to be able to tell us if you can rather than ...

Mr Burrill: We do not keep these things.

(Ev. 3007)

In subsequent discussion with the Committee, Mr Burrill was unable to recall how the precise calculations had been obtained. At one point he commented: 'Why on earth we came out with 3.56, I do not know. I wonder whether it was a misprint and should have been 3.50' (Ev. 3008). But it was pointed out to Mr Burrill that all the assay results in the announcement purported to have been calculated with great accuracy. Mr Burrill also thought there had been a general comparison of the Sheen results with all the Geomin figures (Ev. 3009), but even then he was unable to explain how the published percentages had been obtained. He remained convinced, however, that the action they had taken had been appropriate to the circumstances.

Mr Burrill: ... Maybe it was sloppy, but I think it was the right thing to do. For the first drill hole I do not consider it the least bit important providing it is in the right order and the whole thing is not a fake.

Mr Shierlaw was also asked to ~plain how the assay results were prepared and, in particular, how the 3.56 percentages had been calculated. He said three geologists and himself (a qualified mining engineer) had been 'involved in the calculation'. He went on to say:

It was four years ago and as far as I am aware it was done in the correct geological manner. Just do not ask me the details now. I could not tell you.

(Ev. 3051)

However, in further discussion Mr Shierlaw did remember that the calculations had been based upon the AAS tests of Geomin's Kalgoorlie laboratory, that these had not been accurate above 1 per cent, and that the announcement to the stock exchange contained no warning to this effect.

Senator Rae: This was a group of directors and the consulting geologist, virtually all of whom were geclogists or mining engineers?

Mr Shierlaw: That is so.

Senator Rae: And this was one of the most exciting finds in recent Australian history. It created a great deal of sensation on the stock market and in fact led to a boom which has been called the 'Poseidon Boom'.

Mr Shierlaw: That is so.

Senator Rae: And it was based upon an approximation as a result of an AAS test, the results of which you has not seen, nor had any of the others seen, but which had been received over the telephone by Mr Burrill and relayed onto you and confirmed by one 5 ft section test in Perth by Sheen Laboratories, and that is all?

Mr Shierlaw: That is so.

(Ev. 3052)

Mr Shierlaw was then asked why he, as a director, had not suggested to the other directors that they explain to the market that the assays were not accurate over 1 per cent. He replied:

The stock exchange sort of demanded at the time that results be given as soon as practicable and the results were given within two working days. We were sort of bound by the stock exchange regulations to give what we considered as then an accurate assay result.

(Ev. 3052)

The Committee's final witness on the question of these assay results was Mr Francis Charles Nagy, a chemical engineer, specialising in analytical chemistry. He appeared as general manager of Geochemical and Mineralogical Laboratories (W.A.)Pty Ltd. Mr Nagy confirmed that the Kalgoorlie laboratory had not been equipped to carry out AAS tests which would indicate accurately the nickel content above 1 per cent. He believed that the employee who had released the assay results of the samples containing more than 1 per cent nickel had, in each case, rounded the assay figure down to the nearest whole number. In his view, it was 'quite impossible' for the Poseidon report of 1 October to have been based upon the analytical work completed by Geomin at that time (Ev. 3133).

To summarise: the phenomenally high assays which were published on 1 October were based upon the information which had been gained improperly from Geomin's Kalgoorlie laboratory by the company's geologist and which the directors knew at the time was unreliable. Instead of being candid about the basis on which the assays had been calculated, the directors couched their announcement in such a way that investors were led to believe that proper scientific tests, of high accuracy, had been carried out. This deception continued when, two days later, after the true assays were received from Geomin, no steps were taken to inform the market that there had been an over-estimation of the nickel content of the massive sulphides. While the difference was not large (the true nickel assay for the massive sulphides turned out to be 3.17 per cent as against the 3.56 per cent already announced) this does not excuse what, in our view, was irresponsible reporting. The difference could have been much greater and the market more seriously misled. Mr Shierlaw's explanation that the directors were 'sort of bound' by the stock exchange regulations to release assays in such a form demonstrates not only a lack of knowledge of the stock exchange requirements at that time, but a disturbing unconcern for his responsibilities as a director of a public exploration company.

Fuelling the Boom: Realising Profits

Between 21 and 30 October 1969, about three weeks after the announcement of the assay results, the share-trading company run by Burrill and Associates sold 3,000 Poseidon shares at prices between about $27 and $36, yielding a total amount of $103,922o All the sales were made through Mr Shierlaw's broking firm. Although a substantial profit was realised from these transaction, far greater profits were obtained from further sales carried out between January and March 1970. Before quantifying the amounts involved in these later dealings, however, we discuss the event which had a major influence on the market at that time, opening the way for the realisation of such high profits.

A Triumphant Meeting

It is difficult today to imagine the extraordinary interest which focussed on Poseidon's annual general meeting in Adelaide on 19 December 1969o The previous year, when the company's shares were selling for just a few cents, there had not been a quorum. In 1969, about 400 shareholders filled the hallo Many people whose transfers covering their share purchases were not registered in time were turned away. Others were accommodated in an adjacent room where loud-speakers had been installed to relay proceedings. Representatives of the national press attended, and at least one London stockbroker said he had flown out especially for the meeting. Reports of the day's activities referred to the 'electrified atmosphere', and this in part would seem to have arisen from tension introduced by the angry comments of some shareholders who opposed the placements. But most shareholders appear to have turned up for other reasons. Numerous rumours had been circulating, but there had been little information released by the company since the announcement of the phenomenally high nickel assays. At the end of November, the directors had said that 'comprehensive up-to-date geological information' would be given at the annual meeting. Many investors had, it seems, come to believe that 19 December Would be the day of revelation. They were not let down.

Following the completion of the formal business, the chairman, Mr T.A. Hutton, addressed the shareholders. After a few preliminary words, he said:

It is my pleasure to announce that a major mining operation will be possible on our Windarra prospect.

One report of the meeting described the opening statement as being received by 'a tremendous and prolonged cheer' Sydney Morning Herald, 20 December 1969. Mr Hutton's address continued as follows:

I should like to impress on you immediately the short time that has elapsed since we announced our first economic intersection - that was less than three months ago.

Bearing in mind the time required to develop sufficient ore at such places as Kambalda, Scotia and others, I think you would want to join me in congratulating Messrs Burrill and Associates on their efforts.

This is a most exciting time and I should like to assure you all that your board will be making every possible effort to commence operations as soon as practicable ...

Over the last two months or so you have heard all sorts of rumours and speculations.

This board does not propose to add to the speculation, but says it is not possible at this time to state the size of the operation or the time at which it will commence or the ore reserves on which it will be based. However, it is expected that it would be a major operation.

It seems that some significant alterations were made in the wording of this statement after it was first prepared, for in the copy filed with the stock exchange, Mr Hutton's references to the proposed 'mining operation' did not describe it as a 'major' one. The final sentence in the stock exchange copy read: 'It is expected that it would be at least a substantial operation'. Apparently a decision had been made to up-grade the 'substantial' operation into a 'major' one just before the meeting was held. This rapid build-up continued when, after completing his brief address, Mr Hutton introduced Mr Jones from Burrill and Associates and asked him to 'outline' to shareholders the features of what he then called a 'magnificent discovery'. Mr Jones was not asked by the directors to disclose his and Mr Burrill's financial interests in Poseidon shares, and he did not himself reveal this information to the meeting.

In an important part of his prepared address, Mr Jones went much further than Mr Hutton in discussing what he called 'Ore Potential - Shirley Zone'. We quote the section which was to receive extensive publicity:

Your board has considered carefully the manner in which the ore potential has been assessed and wish you to have the complete information at this time. A line drawn on the longitudinal section around the [Shirley] zone in which drilling has <u>positively indicated ore</u> contains approximately four million long tons. <u>This ore</u> is only a small proportion, that is, 1,300 ft in length and some 600 ft in depth of a long and probably much deeper zone in which drilling must ultimately be undertaken.

It is not therefore possible to give any indication of the total ore potential for the Shirley zone.

It is expected that the overall ore zone will plunge steeply, hence ore should continue to a considerable depth. The assay data to date has indicated consistent nickel values ...

(emphasis by Committee)

The widespread interpretation of this statement was that the drilling which had been carried out over the three months following the discovery had led the company to conclude that it had already established 'positively indicated' ore reserves of four million tons in the Shirley zone. By itself, the second sentence quoted above did not quite support this conclusion, but the opening words of the next sentence, 'This ore ...', were taken as referring to the 'four million long tons'. In addition, the rest of the passage from Mr Jones' address led the market to believe that far greater quantities of ore were shortly to be added to this total. Thus although Mr Hutton had explicitly said it was not possible to state the size of the ore reserves, Mr Jones' subsequent statement had the effect of overriding his remarks. For instance, an extensive report of the meeting by the Sydney Morning Herald, 20 December 1969, carried the headlines on the front page: 'Poseidon's 4m tons of ore confirmed'.

When Mr Jones was giving his final evidence, he was questioned about his remarks concerning the 'ore' within the Shirley zone. He confirmed that he did intend to say that drilling had 'positively indicated approximately 4,000,000 long tons of nickel bearing ore'. He did not believe, however, that the Press reports of 'confirmed ore' were correct.

2.87

Mr Jones: So we had a line on a map saying here is a zone 1,300 ft long, 600 ft deep vertically into the earth and approximately 60 ft in width which would contain 4 million long tons.

Senator Rae: Four million long tons of what?

Mr Jones: Of ore.

Senator Rae: That is of nickel?

Mr Jones: I beg your pardon - of nickel copper ore.

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Senator Rae: ... Another headline was: 'Poseidon's 4,000,000 tons of ore confirmed'. Did you think that the Press were correctly reporting what you had intended to convey?

Mr Jones: I think I could show that I have had long arguments with the Press. I do not believe I have ever believed that they correctly report everything.

(Ev. 3093-4)

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Senator Rae: What you were saying in your report was that drilling had positively indicated approximately 4,000,000 long tons of nickel bearing ore?

Mr Jones: That is correct.

Senator Rae: And so the Press report 'Poseidon's 4,000,000 tons of ore confirmed' is not a great variation from your own language, is it?

Mr Jones: Well it is technically, because confirmed is proven ore; 'positively indicated' is not proven ore.

(Ev. 3094)

Mr Shierlaw was also questioned about Mr Jones' statements and the Press headline: 'Poseidon's 4 million tons of ore confirmed', and he eventually replied that it was a 'fair report' of what was said by Mr Jones. He then went on to say, however, that 'It was ore potential rather than ore confirmed or reserved. I think this is the point' (Ev. 3074). Mr Shierlaw also said that at a later date the chairman of Poseidon denied that the company had said it could claim '4,000,000 long tons of ore' within the Shirley shoot. Investigation by the Committee showed that, in July 1970, Mr Hutton had been reported as refusing to say whether there was 4 million tons of commercial nickel-bearing ore in the Shirley shoot when asked a question on this subject from a journalist at a Press conference. He was also reported as saying he was not sure whether the board had ever specified the figure of 4 million tons (Sydney Morning Herald, 7 and 8 July 1970). It was, of course, Mr Jones who had given the impression in December 1969 that sufficient drilling had been carried out to establish 'positively indicated' ore of 4 million tons within the Shirley zone, and in view of the fact that his remarks were made at the company's annual general meeting, it had been naturally assumed that they had the imprimatur of the directors. Certainly they were widely and repeatedly referred to in Australia and overseas.

After receiving the foregoing evidence from Mr Jones and Mr Shierlaw, we wrote to Mr Hutton. In his letter in reply (Committee Document 2-7), Mr Hutton said:

I am quite sure that Mr Jones did not say or imply that there was positively indicated ore of 4 million tons.

Mr Hutton also stated:

The interpretation given in your letter Ethat Mr Jones had implied that the company had 4 million tons of ore confirmed] could not reasonably be placed on the statement made by Mr Jones if the full statement is read carefully.

Thus we have the disquieting situation of two directors of Poseidon, Mr Hutton (the chairman) and Mr Shierlaw, and the company's geologist, MrSones, contradicting each other about the meaning of what was said at the 1969 annual general meeting. Mr Jones said he did mean to say that the company had 'positively indicated' ore of approximately 4 million tons, but he did not believe the Press report of 'confirmed ore' was correct reporting. Mr Hutton, on the other hand, said Mr Jones 'did not say or imply' that there was 'positively indicated ore of 4 million tons'; and Mr Shierlaw said that the Press report of 'Poseidon's 4 million tons of ore confirmed' was a 'fair report' of what Mr Jones said.

The annual general meeting was, then, a remarkable occasion. Without giving any details of the size and timing of the planned development of what he called a 'magnificent discovery', the chairman, nevertheless, greatly raised the already exaggerated expectations of investors by twice assuring them that a 'major operation' would be established. And there can be little doubt that Mr Jones' words, when considered in the context of Mr Hutton's elated and optimistic generalisations, were seized upon by investors and provided a foundation for the build-up of further market interest in the Poseidon company and the raising of the share price to fanciful levels. The only indication of what the size of the ore reserves might be were given by Mr Jones, and his comments were delivered in such a way that they misled the market. The Committee has not attempted to find out just what would have been a fair statement of the volume of ore within the Shirley zone in December 1969, given the drilling that had been completed at that date, but it now appears that there was a lack of agreement and great confusion within the Poseidon board about what had been established at that point. At the very heart of the company there seems to have been no real belief that 4 million tons of ore had been outlined. Yet, the statements by Mr Jones played a major part in stimulating one of the most spectacular share market booms of recent times and in creating the conditions for the promotion and flotation of numerous nickel exploration companies. To cap off this exultant meeting, the chairman concluded with the remarks: 'I see no reason why any shareholder in Poseidon should not have a wow of a Christmas'.

The immediate response of the market was to run up the price of Poseidon shares to $130, a rise of $30 for the day. The next day the Herald reported upon the events of Friday, 19 December, as follows:

Poseidon was a major item on BBC radio news broadcasts. Newspapers splashed the news of the ever-rocketing share prices. The Evening News led its front page with the banner headline 'Wonder Share Starts London Goldrush'. The paper said: 'The most valuable hole in the world sent dealers scrambling wildly in the London Stock Exchange today.

... yesterday confirmed the market's most optimistic hopes. And it took a great load off shareholders' minds. That was obvious from the 'grand final' style roar that went up from more than 400 throats ... when, after two frustrating hours of legal bickering over the controversial share placement, chairman Tom Hutton rose and delivered the goods ...

Within twelve days of the annual meeting and the statements of Mr Hutton and Mr Jones, the price of Poseidon shares doubled from $100 to $200 and, led by Poseidon, the prices of numerous mining and exploration shares jumped, taking the Sydney Stock Exchange share index for non-ferrous metals from 5101 to an all-time peak of 5870 (reached on 29 December). Poseidon's geologists then set about realising the profits gained from their earlier and timely purchases.

Geologists' Sales

Between the end of December 1969 and March 1970, Messrs Jones and Burrill carried out their large-scale selling of Poseidon shares through Mr Shierlaw's broking firm and through Sydney brokers, Pring, Dean & Co. Extensive trading in Poseidon shares was also conducted through S.G. Brearley & Co., the Perth broking firm run by Mr G.I. Hynam, the chairman of the Perth Stock Exchange. These sales and trading activities were on account of Burrill and Associates and Burrill Investments Pty Ltd, the share-trading company run by Mr Burrill and Mr Jones and associated with their geological consulting business. Details of the selling transactions follow.

On 31 December 1969, 2,000 Poseidon shares were sold for Burrill Investments through Pring, Dean & Co. at prices between $212 and $204 a share for a total sum of $404,456. From 5 to 7 January 1970, a further 2,000 shares were sold for Burrill Investments through Mr Shierlaw's firm at prices between $205 and $220. The total amount obtained from these sales was $422,111.

On 20 January, Burrill and Associates sold 500 shares through Mr Shierlaw at prices between $196 and $205 for a total of $100,119.

Then, on 27 February, Burrill Investments began the sale of another 2,000 shares through Pring, Dean & Co.; these sales took place at prices ranging from $210 to $235 and, by the time they were completed on 23 March, a sum of $431804 had been realised.

The trading through Mr Hynam's firm was for Burrill Investments and involved, first of all, the sale of 1292 shares on 24 February at a price of $230 a share and, subsequently, the purchase of the same number of shares at lower prices of $212 and $215 a share between 12 and 16 March. We will be commenting further about the nature of these dealings but here we note that they realised a profit of about $7,700.

In addition to the foregoing transactions in Poseidon shares, Messrs Burrill and Jones traded in the shares of two companies which were closely associated with Poseidon and whose share prices tended to reflect movements in Poseidon's price. One of these companies was North Flinders, which had received 50,000 Poseidon shares in the placement at $6 a share. Mr Jones was also the geologist to North Flinders (Ev. 199). (This was a further instance where the geologists followed the practice of trading in the shares of the company to which they were consultants.) On 5 January, Burrill and Associates sold 10,000 North Flinders shares through Mr Shierlaw's broking firm at prices between $3.70 and $5 for a total amount of $45,924. Before the Poseidon discovery these shares had been selling for 50 cents each.

The other company was Samin which, as we have noted, had acquired 200,000 Poseidon shares at the placement price of $5 a share, There had been a great rush of applications for the Samin shares at 50 cents each when the prospectus appeared on the market, no doubt due largely to its association with Poseidon and to the huge capital profit it was showing on its holding of Poseidon shares. By the time Samin scrip was first quoted on the stock exchanges on 15 January 1970, the market value of the Poseidon holding which had cost $1 million was about $42 million. Those fortunate enough to receive an allotment in the Samin float saw the shares sold on the opening day at $20, which provided the sellers with an immediate capital profit of 3900 per cent on the cost price. We have previously noted how Burrill Investments was allotted 3,000 shares in this flotation. On 19 January all of these shares were sold through Mr Shierlaw at $19 each for a total sum of $56,016.

To summarise, between October 1969 and March 1970, 9,000 Poseidon shares had been sold for $1,364,293 on account of Burrill Investments and 500 Poseidon shares had been sold for $100,110 on account of Burrill and Associates. These 9,500 shares had cost less than $10,000, so that the realised profits were over $1.4 million. Further large profits were obtained from the similarly timed sales of Samin and North Flinders shares. In addition, trading in Poseidon shares during February-March 1970 had produced a further profit of $7,700. One of the firms which effected these sales belonged to Mr Shierlaw who, as we have noted, had previously bought many of the shares on the geologists' instructions. When Mr Shierlaw was asked by the Committee why the geologists had not been required to disclose their interests to the annual general meeting, he replied that 'it was an oversight' (Ev. 3073). Mr Shierlaw was also asked whether he had been concerned at the geologists' selling orders which had followed almost immediately after the meeting. He replied: do not think it is my problem. I think it is Mr Jones's'(Ev. 3075). So after playing a major role at the annual general meeting which had so influenced investors' expectations of the nickel deposit, and without at any stage during this meeting, or subsequently, declaring their interests in the shares to shareholders, the geologists went ahead with the realisation of enormous profits from the sale of Poseidon shares for their geological business and their share-trading associate. The Poseidon director who had countenanced and facilitated the earlier purchases also, in his dual capacity as a director and a broker, countenanced and facilitated a large proportion of these sales.

A Total Breakdown of Regulation

Mr Geoffrey Ian Hynam, the chairman of the Perth Stock Exchange was first called to give evidence on the regulatory procedures followed by his exchange before he was examined in detail in respect of the action his exchange had taken to investigate the allegations of insider trading in Poseidon shares. In general evidence, Mr Hynam assured the Committee that Western Australia was an 'unblemished State' (Ev. 190). The stock exchanges had their own 'police force' he said, and he thought that in Western Australia it had been 'aptly demonstrated that the close liaison between his exchange and the Registrar of Companies was a workable arrangement which protects the interests of the public' (Ev. 188 and 145). He was not aware of 'any suggestion' of brokers or investment advisers engaging in manipulatory practices, and he knew of no improper practices or malpractices in promotions, flotations or trading activities (Ev. 143 and 190). He thought that 'near perfection' had been reached by the stock exchanges in their procedures for querying listed companies on their reports (Ev. 166). (Mr Jones on the other hand was highly critical of what he called the 'inability' of the stock exchanges to 'understand' reports by listed mining and mineral exploration companies, see Ev. 197). Mr Hynam did not know of a single instance of insider trading (Ev. 158), but he said that if he did hear of a rumour he would 'certainly' act to ascertain whether there way any basis for the rumour: 'This is our obligation' he added (Ev. 161)o Mr Hynam also stated that, in the case of the Perth Stock Exchange, 'we regard every complaint as serious' (Ev. 191).

When the Committee turned from considering this general evidence to ask what the stock exchanges had done to investigate the allegations of insider trading in Poseidon shares, particular attention was given to Mr Hynam's actions as chairman of the Perth Stock Exchange. There were several reasons for this interest. First, from the earliest days of the Poseidon boom, there had been repeated suggestions in Perth of insider trading, as well as several calls in the Press for a stock exchange inquiry. Secondly, the case seemed to provide an opportunity to see how the regulatory 'police force' of the Perth Stock Exchange, in which Mr Hynam expressed such unrestrained confidence, went about its work. Our third reason was that we wished to know how Mr Hynam had resolved his conflicting interests; for in addition to being chairman of the stock exchange he had business associations with Mr Jones and Mr Shierlaw (Ev. 479), and he had also been personally interested in Poseidon shares as an investor, a trader in his firm's house account, and a broker.

Complaints

Mr Hynam was in close touch with events taking place in the Poseidon market before the public announcement of the discovery. He told us how he had observed the rising prices of Poseidon shares on 25 and 26 September (Ev. 484), and on 25 September he had read the director's announcement that they knew of no reason for the rise in the share price. His reaction at the time had been to telephone the Adelaide Exchange 'without doing anything official' in order 'to find out what was doing' (Ev. 485). We will shortly be discussing how Mr Hynam bought 2,100 shares for himself following this phone call (EV. 494).

Early the following week, after the announcement of the discovery, the sudden and continuing rise in the price of Poseidon shares would presumably have brought this stock to the attention of most if not all the other members of the Perth Stock Exchange Committee. Also, on Tuesday, 30 September, as we have noted, the West Australian asked for a stock exchange inquiry into what it believed had been a leakage of information about the discovery. On another occasion that week, a similar call was made for an inquiry. Although Mr Hynam told us that 'obviously somebody knew something' (Ev. 484), he took no action as chairman of his stock exchange to collect records of his members in order to try to find out who that 'somebody' was.

Several weeks then lasped before one Perth investor, Dr Max Kimberley Anderson, who had sold his Poseidon shares on 26

September after reading the directors' announcement of 25 September, wrote to Mr Hynam as chairman of the Perth Exchange complaining that he had sold while others were 'in the know'. Extracts from Dr Anderson's letter follow.

I am concerned to read in last Friday's Financial Review ... that the consulting geologists, or companies with which the geologists were associated, were purchasing significant numbers of Poseidon shares for 2-3 months prior to the directors' two statements in Sept. to which I referred ...

It would appear to me that either the directors realised the potential of the area being tested at Windarra - even before actual assay figures were available - and failed to inform their shareholders of their knowledge, or, alternatively, that the consulting geologists appreciated this potential but did not inform the directors ...

In this letter of 23 November, Dr Anderson asked if the stock exchange was going 'to take some action on behalf of the shareholders'. Mr Hynam did not reply.

On 7 December Dr Anderson wrote again to Mr Hynam requesting a reply. He also asked if Mr Hynam believed there were grounds for 'litigation against the Poseidon directors and geologists'. On 8 or 9 December Mr Hynam telephoned Dr Anderson. The record we have of what Mr Hynam said in this conversation is contained in a letter (dated 21 January 1970) by Mr Hynam to Mr G. Eyres, a member of the Perth Exchange, and Dr Anderson's broker in the Poseidon transactions (Ev. 482).

According to Mr Hynam, he told Dr Anderson to take the matter up with his own personal sharebroker and to address complaints to the Adelaide Exchange, which was the 'home exchange' for Poseidon. The practice of the Australian stock exchanges of having a 'home' exchange is designed to centralise all reports and complaints regarding each listed company. The exchange chosen for this purpose is generally the one located in the same city as the company's head office, which facilitates the administrative arrangements of dealing with a company's management. Mr Hynam told Dr Anderson that as Adelaide was the home exchange for Poseidon, his letter 'had not been discussed by [the Perth] Committee, and we were therefore not in a position to express our views'.

But even if, at that stage, the stock exchange committee had no views, its chairman did, and he proceeded to express them to Dr Anderson. Based upon his 'knowledge of the facts' Mr Hynam said, 'he was satisfied that the directors and consulting geologists had acted most honourably'. Mr Hynam also expressed the view that Dr Anderson had 'misinterpreted' the director's announcement of 25 September. This announcement, said Mr Hynam, 'was made by pressure being brought to bear by Sydney and/or Melbourne Stock Exchange; and at that point of time no information was available'. He added that he had been 'informed' that the statement 'was completely factual at that time'.

Another six weeks passed without Mr Hynam taking any further action. Then, on 23 January, Mr Hynam wrote to Dr Anderson to say he was 'entitled to the courtesy of a written reply' to his two earlier letters of November and December. In this reply, Mr Hynam again said that Dr Anderson should direct his queries to the secretary of the Adelaide Exchange who had been asked by Mr Hynam 'to set out in chronological detail the events which led up to the sharp market rise' and send this schedule to Dr Anderson or his brokers. As Dr Anderson's letters showed that he was already familiar with the order of events, the relevance of his action is not clear. In any case, the information was not sent to Dr Anderson (Ev. 185).

<u>Explanations</u>

Although Adelaide was the home exchange for Poseidon, there had unquestionably been heavy trading on the Perth Exchange on the two trading days preceding the first announcement of the discovery. The Committee was therefore concerned to know why Mr Hynam had consistently refused to take any investigatory action in response to Dr Anderson's letters. Mr Hynam gave several explanations of his behaviour. To begin with, he said:

Quite frankly, we must remember that Dr Anderson at no time made an official complaint to the Stock Exchange at Perth, as required under the rules and regulations, I believe.

(Ev. 186)

When he was then asked if Dr Anderson had been informed that his letter did not constitute an official complaint, Mr Hynam replied:

No. I would not want to be that small. I believe I extended him every possible courtesy.

(Ev. 186)

It seems to us doubtful if Dr Anderson was treated with reasonable respect by the Perth chairman, and subsequently Mr Hynam told us he thought he had been 'discourteous' (Ev. 490 and 492). But at any event, the Perth Exchange did not carry out an investigation, and Dr Anderson was not asked to put his complaint in the official form.

Another of Mr Hynam's explanations was that, at the time Dr Anderson made his complaint, he did not regard it as 'very serious' (Ev. 485). This presumably explains why Mr Hynam considered his telephone call to Dr Anderson in early December as a 'public relations exercise' (Ev. 492). Yet, Mr Hynam had previously told us that he regarded all complaints as 'serious', and in his previous testimony he had insisted that if he heard of a rumour relating to restricted trading he would investigate to see if there was some basis for it (Ev. 160). Mr Hynam also admitted to the Committee that there had been 'a public outcry' over the events surrounding the Poseidon discovery.

Senator Wheeldon: Would you say that, whether fair or unfair, there was no public or Press criticism of the Perth Stock Exchange in relation to Poseidon at that time?

Mr Hynam: There was criticism, but it was not well informed criticism.

Senator Wheeldon: Whether it was informed or ill informed, you would not deny that there was fairly considerable criticism.

Mr Hynam: That is right.

(Ev. 498)

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Senator Rae: When the comments continued to be published in the Press, urging inquiries into Poseidon, what further steps did you or your committee take?

Mr Hynam: Very little. The committee and the members were satisfied that this was a public outcry ...

(Ev. 498)

A third explanation related, it would seem, to those already given, was expressed by Mr Hynam as follows:

... Quite frankly, the number of this type of letter - unsubstantiated, through ignorance or through pique -is quite considerable, and very seldom does one have merit or reason for the stock exchange to take action. This was discussed briefly and openly with our committee. Our committee's attitude was: 'Here is a man who had made some money and who could have made more, and he wants to make somebody the scapegoat and not himself'. Then we took it seriously and had to go into it. We found that everything had been done strictly according to the rules and regulations.

(Ev. 489)

The aspect of the complaint the stock exchange committee took 'seriously' was a suggestion that Dr Anderson's shares might have been bought by his own broker, and it was in this respect that the stock exchange found that the 'rules and regulations' had not been breached. Mr Hynam carried out this investigation in January 1970 (Ev. 490). But no attempt was made to inquire whether there had been insider trading, which was what Dr Anderson was concerned about.

The Referral to Adelaide, Non-referral to the Registrar of Companies

Mr Hynam's main explanation of why he took no further investigatory action in Perth was expressed in these words:

> If you read Dr Anderson's letter you see that his main bone of contention, as I understand it, is against the directors and/or the geologists - not any sharebroker. Therefore, it was not in my province to interfere ... It was not my prerogative as I understand it, to check with a company and/or the directors or the geologists. I made this quite clear to Anderson in our telephone conversation on the 8th or the 9th.
>
> (Ev. 490)

The implication here is that as Perth was not the 'home' exchange, it was not its responsibility to investigate, and Dr Anderson was asked to direct his complaints to the Adelaide Stock Exchange.

Dr Anderson did write to the chairman of the Adelaide Stock Exchange on 29 January 1970 expressing his concern that there had been insider trading. We quote a section of his letter:

> It would now appear to me that either the directors realised the potential of the field at Windarra, even before actual assay figures were available, but failed to notify the shareholders ... or, alternatively,

the geologists appreciated this potential but did not inform the directors. Whichever of these two alternatives is correct the fact remains that, like myself, many shareholders were guided by the directors' reports and sold while people 'in the know' were able to capitalise on this lack of official information ...

The president of the Adelaide Exchange, Mr D.I. McArthur, replied on 5 February. A section of his letter reads as follows:

I unhesitatingly say that it is not for me to say whether or not statements were made were a true indication of the knowledge directors possessed. When asked for a report the directors offered comments and these were accepted by the Exchange as all that was necessary at that time and this placed an obligation on the directors' shoulders.

It is easy to look back now and suggest what could have been done. As individuals we may all have different ideas looking back, but the decisions at that time are the important ones. Those buying shares at that time took a risk that their interest in them was justified.

Senate, Debates 1970, vol. 43, p. 495

Now it should be noted that the stock exchanges have no power to send investigators into the offices of listed companies or their geologists. Any investigation by the Perth or Adelaide stock exchanges into aspects of trading in Poseidon shares, if it had been carried out, would have been limited in this way. Nevertheless, these two stock exchanges could, at any time, have acted separately or together to obtain from their own member firms all details of the buying and selling in Poseidon shares during the period concerned. A joint investigation would immediately have shown the large buying on 25 and 26 September by people associated in various ways with Poseidon, or the geologists, or one of the directors. Mr Hynam's buying of 2100 shares for himself on 25 September would also have been revealed by such an analysis. However, Mr Hynam took no steps within the Perth Stock Exchange to have this elementary procedure carried out and, as we will now show, the Adelaide Stock Exchange was equally ineffective in its regulatory action.

After many of the events described in this chapter had become clear to us, we wrote to the president of the Adelaide Stock Exchange to ask if the exchange had ever conducted an inquiry into the allegations of insider trading in Poseidon shares. The assistant secretary of the exchange replied as follows:

No formal representations were received by this Exchange alluding to instances of insider trading in Poseidon shares and accordingly no investigations of this nature were instituted by the Committee.

Subsequently we wrote to Mr D.I. McArthur, who had been president at the time the allegations were made and who had, as we have seen, answered Dr Anderson's letter of 29 January 1970o He said in reply:

Regarding alleged insider trading I support the advice of the Secretary of the Stock Exchange viz. that no formal representations were received by the Exchange alluding to instances of insider trading and accordingly no investigations along these lines were instituted by the Committee.

So far as I am concerned, I was not aware of any cases of insider trading, nor was anything brought to my notice which made me suspicious that such may have been going on.

I also advise no trading records of member firms were collected, and no investigatory action was taken by me as President.

(Committee Document 2-8)

It seems an incredible instance of complacency that, in spite of the great publicity about the trading in Poseidon shares, Dr Anderson's letter of 29 January 1970, the debate in the Senate, and this Committee's public inquiry, a stock exchange could subsequently explain its failure to investigate on the technical grounds that a particular rule of that exchange covering the making of formal complaints had not been complied with. Yet that was the only explanation given by the Adelaide Stock Exchange.

This is another point at which we can compare Mr Hynam's general assertions with his specific actions. Almost in the same breath as Mr Hynam admitted that he had not collected trading information from his own members, he was willing to argue, however, that investigations of such matters as insider trading 'can be handled very quickly by those on the spot'. He added, 'it is very difficult for somebody outside to get onto these things' (Ev. 498). When giving his general evidence, Mr Hynam was also asked the question:

If there is an allegation that a broker, a director or a geologist of a company listed in, say, Sydney, has been engaged in trading on inside information not disclosed on the Perth Exchange, is that a matter for the home exchange of Sydney or is it a matter for Perth?

He replied:

I think we would all poke our noses into it to try and see that the right thing was done if this did happen. I believe this is more in the area of the Registrar of Companies than the stock exchange.

(Ev. 170)

In the case of complaints about the Poseidon market, there was no sign whatsoever of either the home exchange of Adelaide or the Perth Exchange reacting in the way described by Mr Hynam.

A further part of Mr Hynam's evidence which should be recalled is the statement he made about the stock exchange's relationship with the Registrar of Companies in Western Australia. Mr Hynam said that there was a 'very close liaison' between these two bodies (Ev. 157) which was 'a workable arrangement which protects the interests of the public' (Ev. 145). However, our investigation showed that, even though Mr Hynam was aware of the limitations on the scope available to a stock exchange investigation into trading in Poseidon shares, he did not, at any stage, refer the complaint to the Registrar. Mr Arthur Charles Manning, the Acting Registrar of Companies in Western Australia, told us that there had been no specific complaints on insider trading, and no complaints in relation to the affairs of geologists who act as consultants to public companies (Ev. 223-224). There had of course been widespread discussion of the complaints in the Western Australian and national Press, but presumably the offices of the Registrar did not regard these as coming within their jurisdiction or warranting investigation. Mr Manning also said that he did not have power 'to examine the ledgers or other documents in the custody of brokers and showing the business of brokers ' (Ev. 224).

Whether there really was the 'close liaison' between the chairman of the Perth Stock Exchange and the Registrar of Companies in Western Australia as described by Mr Hynam seems highly doubtful, as was indicated by the following evidence.

Senator ~heeldon: o.. You have said that you have a close relationship with the Registrar, Mr Manning and his predecessor and that this is for the purpose of advising him of any improper practices?

Mr Hynam: And vice versa.

Senator Wheeldon: On how many occasions during the past, say, two or three years, have you advised the Registrar of improper practices taking place at the Exchange?

Mr Hynam: I do not think we would have advised him of any improper practices.

Senator Wheeldon: How many improper practices would he have advised you of?

Mr Hynam: He would not have advised us of any.

Senator Wheeldon: He would not have advised you of any and you would not have advised him of any?

Mr Hynam: No.

Senator Wheeldon: Do you meet very frequently to exchange this information?

Mr Hynam: It is an odd phone call - I suppose every three or six months areas of doubt might arise in his mind or in ours.

(Ev. 190)

The combined surveillance of the market by the South Australian Registrar of Companies and Adelaide Stock Exchange seems to have been equally undeveloped and ineffective. In a letter to the Committee of 12 April 1972 the South Australian Registrar replied to questions as follows:

Q: How many matters involving or suspected to involve insider trading have been examined or investigated since 19627

A: No matters involving insider trading have been investigated since 1962.

Q: Have there been any cases or suspected cases of offences under section 124(2) examined by the office? With what result?

A: There have been no cases of suspected offences against section 124(2) examined by officers.

Q: Has any surveillance been maintained on trading on the Adelaide Stock Exchange in the years 1968, 1969, 1970 and 1971?

A: No surveillance has been maintained on trading on the Stock Exchange during the past four years.

The Rest of the 'Police Force'

The regulation of the members of the Perth Stock Exchange and of the Perth market was, and still is, primarily in the hands of the chairman of the stock exchange and the committee. As in all other stock exchanges, the chairman and the committeemen were only part-time at their regulatory jobs, for they were also members of the exchange conducting their own broking businesses. To run the stock exchange, these members employed full-time staff, and the senior executive was known as the general manager. Apart from the chairman, therefore, the exchange's

'police force', as Mr Hynam called it, had, as its key components, the committee and the general manager. We now briefly review the evidence concerning their roles.

When giving evidence to support his view that his conflicting interests had not affected his capacity to act impartially as chairman, Mr Hynam referred to the attitude of the stock exchange committee:

... my committee - and I think I had a pretty strong committee - and my members would have criticised me and taken me to task very strongly had I not played the game; and never at any stage did I receive criticism from my committee or from my members.

(Ev. 498)

But in our view this behaviour of the committee members cannot be taken as evidence that their chairman had acted appropriately; it is, rather, evidence of inefficiency on their part. Knowing of their chairman's personal involvement with the Poseidon geologists and with Mr Shierlaw, it was their duty to take special steps to see that either an objective inquiry was undertaken by the stock exchanges or that the matter was properly referred to the Registrar of Companies. In remaining silent and doing nothing, they were as culpable as their chairman of failing to see that the exchange fulfilled its responsibilities.

It might have been thought that a possible check upon those stock exchange committee members who were reluctant to investigate their own members or have an investigation started which would probe into the operations of their own firms was the relative independence of the stock exchange's general manager. However, Mr Hynam's testimony made it clear that the general manager possessed insufficient independence and no effective power to carry out such a role.

In response to the first question concerning the responsibility and power of the general manager, Mr Hynam said:

> ... He has fairly extensive powers and, in his wisdom, he would not step outside those powers because he knows that his position would be in jeopardy. If he has any doubt he comes to me ....
>
> (Ev. 156)

In subsequent discussions it turned out that these 'fairly extensive powers' related to the stock exchanges 'listing requirements and reports from companies', not to members' activities. Hence the implication seemed to be, that if the general manager tried to regulate members, 'his position would be in jeopardy'. With listed companies, the general manager had power to act immediately, said Mr Hynam, but he went on to say that in the case of the trading floor, where members conducted their business, he had 'very little control or cognisance'.

Mr Hynam said that there were several members known as 'floor governors' who watched the floor trading and could inquire of other members about certain transactions taking place. Again, however, there was no effective power or independence, for Mr Hynam added: 'The member, of course, has the right to refuse ...' In such circumstances the matter could be referred to Mr Hynam, but only on one occasion had this taken place (Ev. 157). When asked specifically if the general manager had 'any power or duty to inquire into dealings at all as opposed to listing', Mr Hynam explained that he had no power and that 'he is more concerned with the administration than with the actual floor trading' (Ev. 157).

In summary, the stock exchange 'police force', which Mr Hynambelieved was so rigorously protecting the public interest, was in the case we have been discussing, quite ineffective. As the Adelaide Stock Exchange also refused to take any effective investigative steps, and there was no evidence of the Western Australian and South Australian government authorities interesting themselves in the questions raised, there was, in our view, a total breakdown in regulation.

Conflicts of a Stock Exchange Chairman

Mr Hynam's direct and indirect associations with the Poseidon company were many and varied. He and his family were close friends with Mr Jones of Burrill and Associates and, according to Mr Hynam, Mr Jones had always been a personal client of his. This broker-client relationship was of the kind whereby Mr Hynam felt he could buy 300 Poseidon shares for Mr Jones' son in October 1969, while the shares were rising rapidly in price without first consulting with Mr Jones (Ev. 3079). In January 1969, Mr Hynam, as a broker, also became a subscriber to the bulletin on exploration news in Western Australia published monthly by Burrill and Associates, and the information in this newsletter was assessed and passed on by Mr Hynam's firm to his clients. We have already mentioned how Messrs Jones and Burrill regularly chartered a plane and flew over the exploration areas in order to spy on the work being carried out by the various companies. This information was subsequently made available to the subscribers to the bulletin including, presumably, Mr Hynam.

While Mr Jones was an adviser to Mr Hynam on certain mining and geological matters, Mr Hynam was, on occasion, a counsellor to Mr Jones on stock exchange affairs. For instance, when Burrill and Associates had sent their report of the Poseidon claims to the Poseidon directors on 11 April 1969, saying that they were 'very encouraging' and 'intensely interesting', Mr Jones sought Mr Hynam's guidance. 'He was so enamoured of the results as given to the directors' said Mr Hynam, 'that he wished to purchase shares, and as a friend he asked me where his conscience lay'. Mr Hynam said that his advice was as follows:

There is no law or rule to prevent you from buying shares but I believe that morally you should inform the directors that you wish to do this. I concluded that that was the action he took.

(Ev. 495)

We have already noted that the share-trading company for which Messrs Jones and Burrill then bought the Poseidon shares was Burrill Investments Pty Ltd. Mr Hynam said that the purchases took place after the directors' report to the stock exchanges on 29 April of the geologists' findings, but our investigations showed that this was not so; the buying was completed between 24 and 29 April. It was also about this time, between 18 April and 15 May, that Burrill Investments took in Mrs Hynam as a significant shareholder, owning nine per cent of the capital.

In the following months of June and July, Burrill Investments bought a further 20,000 Poseidon shares, bringing its total holding to 30,000 shares. Also in July, at Mr Hynam's instigation, Mrs Hynam acquired a direct interest in Poseidon through a purchase of 2000 shares. In view of Mr Hynam's discussion with Mr Jones in April and his other close associations with Poseidon's geologists, it is not difficult to understand Mr Hynam's own initial interest in the Poseidon shares. This interest then apparently grew to the point where Mr Hynam said he became 'rapt in Poseidon' (Ev. 497) and was prepared to advise his wife to make substantial share purchases. When asked by the Committee if he obtained from Mr Jones any information which gave him an advantage over other investors or brokers, he replied:

No knowledge; but, I believe, encouragement. Let us be honest. Certainly, never at any time have I received or seen any technical reports. But, human beings being what we are, Jones would say to me: 'I think we may do well at Poseidon'...

(Ev. 496-97)

On 25 September 1969, the day after the discovery, but 4 days before the public announcement, Mr Hynam then bought 2,100 Poseidon shares for himself. Mr Hynam's explanation of this purchase was that he had been a large buyer of Poseidon shares for his clients from 15 September, and that 'where there are large buying orders a broker tends to overbuy'. He went on to say: 'After clients' orders had been filled, and this was by 25th September, there were 2,100 left over, which I booked to my personal account' (Ev. 478).

For several reasons we have difficulty in accepting Mr Hynam's explanation that the purchase for his own account came about simply because he had been so busy in executing clients' orders that he had overbought. First, Mr Hynam's scrip ledgers show that his firm bought as agent only moderate or small quantities of shares (fully and partly-paid) on each of the four days preceding his purchase of 25 September: 6,100 shares on 19th, 3,200 shares on 22nd, 3,400 on 23rd, and 200 on 24th (a day on which the Perth Exchange was closed). It is not easy to understand how transactions on this scale would have led him to overbuy to the extent of 2,100 shares. Moreover, many of the share transactions in which his firm was involved as a buyer on the days preceding 25th were transactions in which the shares were bought from clients for other brokers (in other words some clients were selling shares). So that compared with his clients' buying orders before 25th, his own purchase of 2,100 shares on 25th was a relatively large transaction. On 25 and 26 September, the two days following the discovery, Mr Hynam's firm was more active in its dealings, negotiating transactions involving 13,100 shares. But again, the purchases for his clients were significantly below this total, for some of the transactions in which Mr Hynam was acting as a broker involved him in selling shares for clients to other brokers. So even during these busy days, it is hard to see how the build-up in his clients' orders led him to overbuy to the extent of 2,100 shares.

Another reason for questioning Mr Hynam's explanation of his purchase is that he said, when discussing his wife's purchase of 2,000 shares, that this had been 'a lot of money' to him (Ev. 493). One would therefore have expected Mr Hynam to have taken considerable care in the placing of buying orders involving 2,000 or more shares. Moreover, if a mistake were made, one would have expected him to have taken the obvious and immediate way out of the difficulty, which would have recouped him his money and might even have realised a profit: to have sold the shares in the rising market which Mr Hynam himself noted was 'in short supply' of the stock (Ev. 478). However, Mr Hynam apparently did not consider this course of action. IT is difficult to reach any conclusion other than that Mr Hynam bought these shares on 25 September as a deliberate act, and for a reason different from that which he stated to us.

Hence, at the time of the public announcement of the discovery, Mr Hynam and his wife held 4,100 Poseidon shares, and Mrs Hynam's shareholding interest in Burrill Investments gave her a 9 per cent interest in a further 30,000 Poseidon shares. It scarcely needs saying that this amounted to a substantial financial interest in the Poseidon company. When, for instance, the shares were selling for about $80 each, at about the time of Dr Anderson's second letter to Mr Hynam in his capacity as chairman of the Perth Stock Exchange, the Hynam's direct and indirect interests were worth over $500,000. Following the annual general meeting, when the shares were selling for about $200 each, the market value of these Hynam interests was well in excess of $1,000,000.

Mr Hynam also acted as one of the brokers to Burrill Investments, obtaining substantial brokerage income from this source. Between September 1969 and March 1970, for instance, he carried out about $1.6 million of share business (both buying and selling) for this account. Mr Hynam told the CommitTee in another context that he ran 'a small to medium size firm', and that for him a large order amounted to about $20,000 or $30,000 of business (Ev. 488). It would appear, therefore, that Burrill Investments was one of his largest clients. An inspection of the records showed that most of the dealings took place in the shares of a large number of different companies associated with speculative exploration or mining. The monthly volume of turnovers was about $50,000 in September, rose to over $150,000 in October and November, but was very much higher in February and March 1970. A series of particularly large transactions took place in Poseidon shares during this period. On 24 February, Mr Hynam sold 1,292 Poseidon shares for Burrill Investments at $230 a share, and later, the following month, between 12 and 16 March, bought 1,292 Poseidon shares at the then lower prices of $212 to $215. The earlier sale proceeds (after the deduction of brokerage) amounted to $290,620, and the purchase cost (after the addition of brokerage) was $282,920. Thus within a few weeks

Mr Hynam had transacted well over $500,000 of business for this one account. His brokerage earnings calculated at the rate of 2 per cent were well in excess of the profit of $7,700 derived from the sale and purchase by Burrill Investments. By any standards, this was a large order, and it is of interest to note that it was concluded only three days before questions were first raised and the failure of the Perth Stock Exchange to investigate the complaints.

It appears that these sales of Poseidon shares carried out by Mr Hynam on 24 February for Burrill Investments were not technically short sales, for Burrill Investments held sufficient shares in its portfolio to deliver to the purchasers. However, as the records showed, Burrill Investments did not 'cover' the sales from the shares they were already holding, but bought back through Mr Hynam, at lower prices, the precise number of shares which had been sold. The transaction was, therefore, similar in nature to a short sale which, at the time, was prohibited by the Perth Stock Exchange. We believe it is relevant to quote the comments of the Senate Report (1934) on such practices in the United States.

A type of sale not technically a short sale, but similar in nature, is a sale 'against the box'. In such a transaction, the seller owns and possesses stock which he can deliver but which for some reason he prefers not to deliver. This is a device which can be employed by corporate officials and insiders who desire to sell their corporation's stock short without disclosing such short selling ... It is contended by stock-exchange authorities that a sale 'against the box' is not a short sale, since the customer need not buy the stock back but may make delivery from the securities in his box. It is plain, however, that where a person initially makes a sale 'against the box' but subsequently changes his mind, there is nothing to prevent him from covering in the open market. In such cases he is indistinguishable from any other short seller.

In addition to the associations already mentioned Mr Hynam was friendly with Mr Shierlaw and their two broking firms conducted reciprocal business (Ev. 478). Mr Hynam was also friendly with Mr B.R. Lewis who played a prominent part with Mr Shierlaw in the flotation of Samin Ltd, and became a director of Poseidon in December 1969. Mr Shierlaw allotted 10,000 Samin shares to Mr Hynam personally in December 1969, the allotment letter being sent to Mr Hynam's home address, not to his firm. Mr Hynam distributed 4,000 of these shares to 23 clients and 'personal associates' and the balance of 6,000 he retained for himself, his wife, and a family company. Later that same month Mr Hynam set about obtaining proxies for the Poseidon directors in order to support them at the annual general meeting at which they were to ask shareholders to ratify the private share placements they had made to Samin and other associated companies. Mr Hynam told us that he thought the directors had done a 'magnificent deal for the company' with these placements (Ev. 493), and that he had not supported the directors in consideration of being allotted the Samin shares (Ev. 478). Nevertheless, he benefitted financially from the allotment, for on the day the Samin shares were first quoted, 15 January 1970, the 6,000 shares which had cost Mr Hynam's family $3,000 were valued in the market at about $120,000.

To begin with, in his affidavit to the Committee, Mr Hynam asserted:

Notwithstanding my shareholding in Poseidon and my friendship with Jones and Shierlaw I do not believe there was any conflict of interest in my position as Chairman of the Exchange.

(Ev. 479)

Subsequently, under examination, he said:

There could be a conflict of interest there. Of course there could be a conflict of interest there. There is no doubt in my mind at all ...

(Ev. 498)

Although Mr Hynam remained confident that he had not let his personal interests influence his actions, it is a fact that at no stage did he take the first elementary steps of carrying out an inquiry into the allegations of insider trading. He resisted all such moves despite his own observance of the sequence of events in the market and his belief that 'someone knew something', in the face of widespread criticism and a call for an inquiry, regardless of Dr Anderson's specific complaints, and throughout the debate in the Senate on the subject and the subsequent publicity attending this Committee's hearings. Mr Hynam was well aware of what an inquiry by him entailed - namely the collection and examination of members' records (Ev. 498) - but he consistently refused to exercise the powers which, in his general evidence, he said he would not hesitate to use (Ev. 157). His explanations for failing to institute an investigation were, in our view, unconvincing and, in many respects, impossible to reconcile with his general evidence.

We have not been satisfied that Mr Hynam's continued resistance to the call for an investigation was not largely to be explained by his unwillingness to risk compromising his personal and broking associations with Mr Jones and Mr Shierlaw; associations which had brought him, through a series of timely share purchases, such an enormous increase in his own and his family's wealth, and which were providing him with a large and continuing flow of broking business.

Concluding Comments

The Committee has concluded that during the period leading up to the announcement of the discovery of nickel and copper sulphides the consulting geologists and one of the directors misused their official and fiduciary positions to buy Poseidon shares for private profit. The geologists also sold many of the shares at a time when they had a greater knowledge of the sketchiness of the prospects than the general public whom they had informed about the Windarra field. Another conclusion of wide significance is that the Windarra announcements, which gave nickel prospecting a new glamour and gave rise to a great wave of mineral company flotations and placement issues, can now be seen to have been misleading in significant respects and made on careless, to say the least, reporting of assays.

When discussing their share dealing, the consulting geologists, Burrill and Associates, said on several occasions that their buying had been done with the knowledge and approval of the Poseidon directors. One of the directors, Mr Shierlaw, agreed that such permission had been given. Mr Shierlaw then went even further in facilitating what we believe was a persistent abuse of confidential knowledge by executing a substantial part of the geologists' buying orders through his own stockbroking firm. He also acted as their broker in carrying out many of the subsequent selling transactions. In our view, Mr Shierlaw was prepared to connive at the dealings because of his own determination to buy the shares for accounts in which he was financially interested at a time when he also possessed an insider's knowledge of the company's affairs. In this case, therefore, the public shareholders could not rely upon their directors to act as their watchdogs in seeing that consulting geologists did not deal in the ccmpany's shares while possessing knowledge which had not been released to the market. Other safeguards were needed.

In considering what these safeguards should be, it is important to note other features of the share transactions we have been discussing. The dealings did not take place on just one stock exchange, but on several, and they involved many different accounts, some of which, on the face of it, did not appear to be connected with people associated with Poseidon. Consider the buying orders for the accounts in which the geologists were interested. Their buying orders were implemented by brokers in Adelaide and Sydney, while they operated out of Perth. Their subsequent selling instructions and trading activities were carried out by brokers in Adelaide, Sydney and Perth. The main purchases were for their own consulting business and their associated share-trading company, but Mr Jones also bought shares for himself and members of his family; he also arranged for some of the shares which were bought on his instructions before the public announcement of the discovery to be subsequently 'booked' to a group of friends and associates. In other words, the insider dealing was not confined to one exchange; it was done through various accounts on the national markets, so that the abuse became a nation-wide problem. As the records of the stockbrokers who handled the various transactions in Australia were located with the members of three different exchanges, it would have needed a decision by all three to collect those records and co-ordinate them for the evidence of the dealing to be revealed.

Now even if there had been such action, much essential information would not have been revealed by such a joint inquiry. As our own experience showed, to understand the circumstances in which the various dealings took place it was necessary to collect records prepared by the drilling company, to inspect the documents covering the movement of drill cuttings, and to examine the reports of assay results prepared by three laboratories. These various documents were located in different places: some were with the Poseidon company, which was based in Adelaide, some were with the geologists, based as we have seen in Perth, and some were with the drillers and assay laboratories in Kalgoorlie and Perth. For a considerable period of time the drilling records were apparently 'missing'; however, at least one set remained in existence, and if this Committee had not obtained access to them and to the assay laboratory records the determination of the correct date of the discovery would not have been possible. In the absence of those records the claim by Mr Burrill, repeated in evidence by Mr Jones, that the discovery was on 26 September - two days after it in fact took place - may then have been incontrovertible. The point to note is that the stock exchanges had no power to call for such records; they would have had to rely upon the State government bodies in Western Australia and South Australia to take the initiative and use their authority to carry out the wide-ranging search and examination. And again, for a proper understanding of this intricate example of corporate and market subterfuge a high degree of co-operation would have been required.

As our Report shows, no such joint action was forthcoming even though there were some matters developed in public and at our hearings which ought reasonably to have placed the various regulatory authorities on notice. Not only was there no joint systematic investigation, but we could discover no sign of any one of the regulatory authorities in Western Australia or South Australia carrying out even an elementary inquiry. We believe this evidence supports our recommendation that a national regulatory body is required to regulate insider dealings on the nation's securities markets.

In considering the powers which should be vested in such a body, it is useful to point to another of the lessons of this case. As our inquiry progressed, it became clear to us that we could not rely upon letters, public announcements, public statements, sworn testimony, statutory declarations or affidavits to reveal the truth. We found that the reports and statements by the directors and geologists were evasive, distorted, exaggerated and simply untrue in important respects. If a regulatory authority is to have reasonable success in protecting the markets from deceptive practices such as insider trading, it must have the power to inquire and obtain all relevant documents and records and it must expect to use that power. It must also have the independence and determination to press its inquiries during a period of a booming share market when there might be little public support or tolerance of such action.

A further important aspect of this evidence adduced before the Committee concerns the activities of stockbrokers. Like many other stockbrokers in Australia (except for members of the Perth Exchange where the rules have explicitly forbidden the practice since 1969, Ev. 142), Mr Shierlaw was not only a stockbroker, but a director of several companies, including Poseidon. In his capacity as a member of a stock exchange, he acted as broker to Poseidon, a very large share trader for his own account in Poseidon shares; an underwriter of a company, Samin, which was closely associated with Poseidon; a sharebroker in Samin shares; and an adviser to his clients on investments in Poseidon and Samin shares. Mr Shierlaw said that his dual roles as a director of public companies and a stockbroker did not involve him in a conflict of interests (Ev. 5027). We disagree. Moreover, we have concluded from the evidence that he used his special knowledge and position as a director in Poseidon on several occasions to negotiate transactions in Poseidon shares which would benefit himself and his associates. In doing so he abused his responsibilities both as a member of the stock exchange and as a director.

We also draw attention here to the newsletter circulated to the clients of Mr Shierlaw's broking firm in May 1973 in which the operations and profitability of Poseidon's two wholly owned subsidiaries were discussed in considerable depth and Poseidon's shares recommended as an investment (Ev. 3026). Included in the review was a detailed calculation of the production, income, expenses and profitability of the company to June 1974. Mr Shierlaw told us that he prepared these forward estimates, but that he 'made a very special attempt not to use any inside information' he had obtained as a director. He argued that the review was based on his knowledge as a stockbroker and mining engineer, not as a director. We do not share Mr Shierlaw's opinion of his capacity to segregate his knowledge as a stockbroker and mining engineer from his knowledge as a director of the company he was writing about and recommending to clients. The fact is the letter contained detailed projections of Poseidon's results for the coming year and, as Mr Shierlaw himself said, it was widely known that he was a director of that company. His comment was:

I think everyone in Australia knows that I am a director of Poseidon and I certainly sent the letter out under the firm of N.C. Shierlaw and Associates, share and stock broker.

(Ev. 3027)

In our view, one of the company's directors was, in his capacity as a stockbroker, telling his clients more about the company than the company had itself told shareholders and the market. This was totally improper. That a stockbroker was still permitted to behave in this way in 1973, three years after this Committee's inquiries began, would seem to suggest a marked reluctance on the part of the stock exchanges to face the need for closer supervision of the activities of their members. In the concluding chapter we return to this general question of broker-directors with specific recommendations.

Elsewhere in this report we deal more fully with the separate question of members of stock exchanges trading on their own account while acting as brokers for, and advisers to, public investors. Here we note briefly that Mr Shierlaw was an example of a broker who combined both functions. He engaged in large-scale share-trading through a house account, which he called a 'London office' account, and a proprietary family company, NCS Securities. In the case of NCS Securities, the staff of the broking firm were also shareholders with Mr Shierlaw and his family, so that there would appear to have been an incentive for the firm as a whole to suggest favourable trading opportunities to this company rather than to clients.

NCS Securities also possessed the valuable privilege of dealing without incurring brokerage charges. Mr Shierlaw said that his reason for not charging brokerage was because he regarded NCS Securities as his 'own' company, even though there were some minority holdings. In further explanation of the relationship of NCS Securities to his own broking firm, he said that when he dealt for NCS Securities he regarded himself as a principal in the transaction and he notified any clients who might also be concerned of his principal role. However, when we checked certain transactions carried out for clients in which NCS Securities had been involved (including one in which a client had sold 1,800 Poseidon shares through Mr Shierlaw to NCS Securities on 25 September 1969), we found that the contract notes were not marked to show that Mr Shierlaw had been acting as a principal, and commission fees had been charged. Mr Shierlaw said that in the instances concerned the clients had been notified of his position 'verbally'. In subsequent discussion, we were informed that it was Mr Shierlaw's practice when he acted as a principal to charge commission on the transactions. In answer to the question: 'Did you charge your clients brokerage where they were dealing with you as a principal' he replied 'Yes' (Ev. 3031).

After commenting that he thought the rules of the stock exchange permitted such behaviour, he added: 'I mean, this is what does happen in practice' (Ev. 3033). Clearly this is further evidence of the weak self-regulatory procedures of the Adelaide Exchange.

We also draw attention to the evidence of the multiple roles of consulting geologists in Australia. Burrill and Associates were not only geological consultants to public companies, but there entangled in a range of activities directly associated with dealings in the shares of listed companies. This entanglement was deliberately organised as an integral part of the firm's business - one side of the business complementing the other. The objective was to make profits. Thus, the firm developed a specialised and well-organised system for gathering information about mining and exploration companies, for disseminating this for a fee among select clients, including brokers, and for dealing in the shares of these companies. This share-trading was so closely integrated with the geological consulting activities that the geologists themselves directly, and indirectly through their associated company, dealt in the shares of the companies to which they were consultants. This dealing took place on a national basis. Mr Burrill also advised international investors on their dealings in Australian shares; and we have said how he made use of his privileged position as the consulting geologist to Poseidon to benefit these investors at the time the placement of new shares was being arranged. In our view, it is intolerable that consulting geologists should have free licence to behave in this way. Yet there was no evidence that any State regulatory authority or professional geological body had ever challenged their conduct. Mr Jones told us (in 1971) that geologists have not been subject to a code of ethics, unless they happened to be a member of the Institute of Mining and Metallurgy (Ev. 202). He was a member of that body, but it apparently did not concern itself with the kinds of practices of geologists we have described.

Views will differ about the extent to which investors in Poseidon shares were misled and the market inflamed by the waves in which the information was released of the discovery, the assay results, the 'major' mine said to be in the planning stages and the 'positively indicated' ore apparently established after only three months' work. During that period, many members of the investing public were buying blindly, and were not concerned with the underlying strength or weakness of the companies they were supporting. But one of the prime concerns of the regulatory authorities must be to see that the information made available to the public is honest, complete and factual. The geological reporting by Poseidon following the discovery did not, in our view, measure up to these standards. It is particularly disturbing that, during the period when the market was reacting to these reports, the geologists should have benefitted very greatly through the sales of Poseidon shares to the market. For these reasons we believe that those aspects of the affairs of geologists such as statements by them in prospectuses and to the market should be within the general supervisory jurisdiction of a national regulatory body.

Another aspect of this case-study which gives cause for anxiety is the evidence that two stock exchanges failed to institute an inquiry into the allegations of insider trading despite the receipt of specific complaints. We have noted how the president of the Adelaide Stock Exchange was active in supporting the Poseidon directors publicly at the company's annual general meeting in 1969 even though he had failed to take any effective investigatory action in respect of the allegations of insider trading and the criticism of the private placements arranged by one of his members, Mr Shierlaw. We have also recorded how the chairman of the Perth Stock Exchange resisted the requests to carry out an investigation, and took no steps to refer the complaints to the Registrar of Companies. He was, nevertheless, prepared to support the actions of the Poseidon directors and geologists throughout this period. In Mr Hynam's case, we have expressed our concern that his immense personal and family gadns from investments in Poseidon, and his close associations with that company's geologists and with Mr Shierlaw, may have led him to subordinate his official obligations. Mr Hynam's general assertions about the efficiency of the stock exchange's 'police force' were, in our view, unjustified. These are some of the reasons why we have concluded that self-regulatory procedures of stock exchange affairs cannot be left primarily in the hands of chairmen who are themselves members of the exchange, share traders and investors on their own account.

CHAPTER 3

FINANCIAL STRUCTURE AND PROFITS OF MEMBER FIRMS OF THE STOCK EXCHANGE

The aim of this chapter is to examine the financial structure and profitability of the member firms of the exchanges, and to consider the effects of fluctuations in the scale of activity, as exemplified in the mining share boom of 1968-70 and its aftermath, upon these firms. This represents the first substantial coverage of the industry's finances, and is intended to correct a situation of almost complete lack of information. No financial data had previously been obtained from member firms of the various exchanges either by the exchanges themselves or by an external body for purposes of statistical collation and analysis. The Committee made arrangements to obtain the financial statements of each firm for the six years 1965-66 to 1970-71. To preserve their confidential character, the statements were coded with the co-operation of auditors representing the exchanges before being submitted to the collating process by the Committee. The results of the collation are presented in a series of tables which are the main substance of this chapter.

While the tables have interest and informative value in the circumstances, and are especially useful for tracing the dynamics of the broking industry over a number of years, it is necessary to observe a number of limitations on the scope for drawing inferences from these figures. In the first place, methods of presentation of the financial accounts were not standardised. The Committee received statements which had already been prepared by each firm according to its past practice. Differences were found to exist not only between exchanges but also among the members of an exchange in matters of definition, in the amount of information given and degrees of dissection of items in the accounts.

One of the main reasons for these variations in the structure and detail of the financial statements is that within the stock exchanges there are firms of many different sizes rendering many different services. At one stage during the six-year period of the survey a large firm had total assets of about $60 million, whereas several firms had assets of less than $20,000. In Melbourne in 1969-70, one firm received revenue of $7.5 million, whereas another firm's revenue was only $7,300. We found that some of the large firms separated their revenue obtained from underwriting, management of associated investment companies, option and share dealing from the commissions obtained from agency business. Several large firms also showed as separate items the profits and losses from dealings as principals in government securities (bonds) and from deposit-taking and deposit-lending. Many smaller firms did not engage in such dealings, and other firms for which non-agency earnings were relatively less important tended to combine all their revenue under one heading. Although there are these great differences between the activities of many member firms of the stock exchanges, they are all referred to as 'stockbrokers', 'brokers' or 'broking firms'. In describing their functions, however, it is usual to distinguish their agency activities, or broking function proper, from their underwriting and dealing activities as principals.

Another point we noted when studying the accounts is that the nature of the business of some firms changed rapidly from year to year during the period of the survey. All firms conducted some agency business for members of the investing public, but for some firms the relative importance of this business varied greatly. For instance, in 1966-67, one Sydney firm had a total revenue of about $814,000, of which $357,000 or 44 per cent, was from commission and brokerage, and the balance from underwriting and dealings as a principal in shares and bonds. In the following year, 1967-68, the revenue from all sources was $1.8 million, of which commission and brokerage was $1.3 million, or 72 per cent of the total. We will be showing how the financial requirements of a firm which directs its interest to principal dealing are different from those of a firm which is organised mainly to provide an agency service to personal clients.

It is also necessary to recognise that the accompanying tables, being derived from the financial records of the member firms, do not embrace the results of any share trading, bond dealing or underwriting activities of separate partners conducted through associated proprietary or public companies. Since a decision whether to channel business such as share trading or bond dealing through the firm which is the member of an exchange or through an associated company can be an arbitrary one, depending partly on tax considerations from time to time, as well as varying with custom from firm to firm, the profit figures in the tables fall short of completeness and comparability.

Our investigation covers the firms which were members of one of the six principal stock exchanges(Adelaide, Brisbane, Hobart, Melbourne, Sydney and Perth) during part or all of the six-year period. It does not include figures from the three much smaller exchanges outside the capital cities, now at Ballarat and Bendigo in Victoria, and Newcastle in New South Wales. The number of operating partnerships covered in the survey varied from time to time as a result of mergers, separations, closures and new establishments. The trend in numbers of firms appeared to vary directly according to the scale of stock exchange activity. The numbers ranged from 154 member firms at June 1966 to a peak of 186 firms in June 1970. By June 1971, the number had fallen to 174 (and the decline has since continued, the number of firms being 165 at the end of June 1975). Meanwhile, despite the varying combinations of members in partnerships, the number of seats, of the size of the personal membership of the six exchanges has been comparatively stable throughout the period. In mid-1975 the number of seats was 440, and this total personal membership of the exchanges (not including non-member partners of broking firms) was distributed as follows: Adelaide, 58; Brisbane, 44; Hobart, 17; Melbourne, 160; Perth, 55; Sydney, 128. A comparatively small and varying number of the seats are unfilled at any particular time. As between Melbourne and Sydney, the tendency has been for Melbourne to have on average distinctly more member-partners per broking firm. Thus, whereas Melbourne had 52 by number (or 25 per cent) more members than Sydney in mid-1973, it had 20 by number (or 51 per cent) fewer broking partnerships than Sydney. The 165 firms operating in the six exchanges at 2 July 1975, together with the number of seats and the average number of member-partners per firm were as follows:

	Stock Exchange seats	Broking firms	Average no. of member-partners per firm
Adelaide ..	58	21	2.71
Brisbane ..	44	18	2.40
Hobart..	17	4	4.25
Melbourne ..	160	45	3.56
Perth ..	33	12	2.75
Sydney ..	128	65	1.97
Six Exchanges..	440	165	2.67

Sydney has had a lower ratio of seats per firm than any of the other exchanges. This is evidently related to the higher prices commanded by seats in Sydney during recent years than in the other cities.

Three exchanges, Adelaide, Melbourne and Sydney, also allow member firms to have partners who are not members of the exchange. Some of these non-member partners share in the profits of the firms of which they are partners, and in other eases they are on fixed salaries. At the time of writing there is only one non-member partner in Adelaide, but in Melbourne and Sydney there are substantial numbers, as seen below.

Non-Member Partners of Stock Exchange Firms

	Melbourne	Sydney
30 June		
1966	nil	25
1969	1	45
1971	42	90
1973 (November)	57	130

The first non-member partner of a Melbourne firm was admitted in June 1969 following the exchange's adoption of new rules allowing such partnerships in April that year. Between 1969 and November 1973 the number of such partnerships increased to 57, while over the same period there was little change in the number of stock exchange members. In Sydney, however, the growth of non-member partnerships has been even more striking; an increase from 45 in 1969 to 130 in November 1975. Over that period there was a decline in the number of stock exchange members from 142 to about 128o

By adopting rules which allow non-member partnerships, these two exchanges have allowed people of ability to become principals of firms without having to provide the substantial capital necessary to buy a stock exchange seat. This would seem to be one reason for the growth in numbers of such partnerships. Another explanation for the recent growth in numbers has probably been the action of the Sydney and Melbourne Exchanges in banning sole traders, that is firms with only one partner. Nevertheless, the continuing expansion of non-member partnerships in Melbourne and Sydney since 1971 suggests that at least sections of the industry have continued to prosper in the post-boom conditions.

One of the restrictions on the growth of individual firms in Australia is that a stock exchange will not admit as a member someone who is a member of another exchange. However, member firms are permitted to open branch offices, and a number of firms have these offices in the other capital cities and regional centres. Several firms have also established branches in London and Europe. Orders obtained by these branches are sometimes directed back to the head office to be executed on the exchange to which the firm belongs, and they are sometimes directed to another exchange, through a member of that other exchange, with an arrangement for the sharing of the commission. In several instances the business conducted by these branch offices has been large relative to the total business of the firms. In addition, the branch business of several Melbourne and Sydney firms in other States has been substantial relative to the total stock exchange business in those other States. So when, in the following analysis, we refer to the accounts of the members of one exchange, it is to be understood that the business of those members has not been generated only in the city after which their exchange is named.

The six-year period to be covered by the survey in this chapter encompassed some wide variations in the tempo of stock exchange business. The first two years, 1965-66 and 1966-67, were 'normal' in the sense that the volume of speculative trading in mining and oil shares represented a minority (though a rising) proportion of total money turnovers recorded on the exchanges. The next three years, ending in June 1970, were a period of boom rising to a crescendo, as the share markets responded, first, to the implications of earlier great mineral discoveries by long-established companies, particularly in Bass Strait oil and gas and in Kambalda (Western Australia) nickel, and later responded to a spate of flotations and announcements of new mining and oil exploration companies, culminating in the

Table 3-1

AUSTRALIAN STOCK EXCHANGES: SOME AGGREGATE MOVEMENTS 1965-66 to 1970-71

Year to 30 June	1966	1967	1968	1969	1970	1971
Reported share sales, four stock exchanges (Adelaide, Brisbane, Melbourne, Sydney)	**$505m**	**$645m**	**$1,982m**	**$2,286m**	**$3,443m**	**$2,386m**
Change from previous year, percent	(-2.3)	27.8	207.3	15.3	50.6	(-30.7)
Revenues of members firms of six stock exchanges[1] (Adelaide, Brisbane, Hobart, Melbourne, Perth, Sydney)	**$20.8m**	**$26.7m**	**$67.3m**	**$74.3m**	**$114.6m**	**$72.1m**
Change from previous year, per cent	-	28.4	151.3	10.7	54.2	(-37.1)

Expenses of member firms of six stock exchanges	**$15.8m**	**$17.7m**	**$35.1 m**	**$47.8m**	**$79.9m**	**$71.7m**
Change from previous year, per cent	-	12.0	98.3	36.2	67.2	(-10.3)
Profits before tax of member firms of six stock exchange:[2]	**$4.9m**	**$8.9m**	**$32.0m**	**$26.4m**	**$34.7m**	**0.4m**
Change from previous year, per cent	-	81.6	259.6	(-17.5)	31.4	(-98.8)

[1]See Table 3-16 for definition.
[2]See Table 3-13 for definition.

Table 3-2

SIX EXCHANGES: AGGREGATE BALANCE SHEETS OF MEMBER FIRMS

	1966		1967		1968		1969		1970		1971	
At 30 June	**$m**	**Per cent**	**$m**	**Per cent**	**$m**	**Per cent**	**$m**	**Per cent**	**$m**	**Per cent**	**$m**	**Per cent**
Proprietors' funds	10.7	13.1	13.5	12.3	34.0	10.5	34.2	10.9	49.4	9.8	32.3	16.8

Bank overdrafts	13.6	16.6	17.2	15.7	57.7	17.9	44.3	14.1	55.6	11.1	25.5	13.3
Other current liabilities	57.6	70.3	78.9	72.0	231.4	71.6	235.4	75.0	396.6	79.1	133.9	69.9
Total funds employed	81.9	100.0	109.6	100.0	323.1	100.0	313.9	100.0	501.6	100.0	191.7	100.0
Cash at Bank	1.6	1.9	2.9	2.7	11.8	3.6	7.6	2.4	12.5	2.5	2.7	1.4
Debtors	29.8	36.4	47.8	43.6	189.9	58.8	190.4	60.7	372.4	74.2	123.6	64.5
Security balances	40.7	49.7	48.8	44.5	69.0	21.4	73.6	23.5	38.6	7.7	23.0	12.0
Bank trust accounts	2.8	3.4	3.7	3.4	18.5	5.7	18.3	5.8	35.7	7.1	13.8	7.2
Deposits and other	6.0	4.5	4.1	31.4	9.7	20.1	6.4	36.6	7.3	22.7	11.8	

assets 4.9												
Fixed assets	2.1	2.6	1.9	1.7	2.5	0.8	3.9	1.2	5.8	1.2	5.9	3.1
Total assets	81.9	100.0	109.6	100.0	323.1	100.0	313.9	100.0	501.6	100.0	191.7	100.0

3.7

report of nickel discoveries by Poseidon N.L. (now Poseidon Ltd) in the latter months of 1969. In the climactic year 1969-70, the combined (gross) money turnovers on the stock exchanges were about seven times as much as they had been in 1965-66 (in Sydney, more than eight times), and trading in the classified 'mining and oil' stocks comprised two-thirds of these turnovers, while a considerable part of the remainder, though classified as 'industrial', reflected dealings in stocks such as The Broken Hill Pty Co. Ltd, which had developed a mineral character. Finally, in 1970-71 there was a thirty per cent subsidence from the turnover of 1969-70, though the volume of business recorded was still higher than that of any other previous year, with 'mining and oil' still accounting for about two-thirds of the turnovers. The first two tables present in summary form some of the salient movements in the aggregate of member firms' accounts for the six exchanges during that period of varying experiences. We now proceed to observe in detail how the firms financed the fluctuating volume of their business over the six years.

Capital and Liabilities of Member Firms

Proprietors' Funds of the Partnerships

The proprietors' funds of member firms, or interest or equity (sometimes called the 'Proprietorship' in brokers' accounts) may be regarded alternatively as being the difference between a firm's total assets and its external liabilities. Thus, proprietors' funds include not only the capital account contributions of the partners and undistributed profits of the partnership, but also term loan accounts and current accounts owing to partners, less any contra loans made by the firm to partners.

The extent of a firm's need for proprietors' funds depends substantially on the nature of its business. In order to carry out an agency function, for instance, a firm requires

Table 3-3

PROPRIETORS' FUNDS OF MEMBER FIRMS
(Year to 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	4,189	5,025	14,402	19,837	27,932	15,828
Melbourne	4,803	6,370	14,043	10,388	13,834	11,518
Adelaide	502	640	2,086	1,133	2,259	1,730
Brisbane	831	832	1,829	1,632	1,866	1,286
Perth	173	422	1,290	893	2,811	1,589
Hobart	204	212	304	335	728	333
Total	10,702	13,501	33,954	34,218	49,430	32,284

Table 3-4

PROPRIETORS' FUNDS AS A PERCENTAGE OF TOTAL FUNDS EMPLOYED
(30 June)

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
	per cent	per cent	per cent	per cent	per cent	per cent
Sydney	12.2	9.9	10.1	10.4	8.7	16.3
Melbourne	11.6	13.1	9.5	10.6	10.6	15.8
Adelaide	20.8	15.4	20.2	15.9	15.3	26.6
Brisbane	34.8	26.7	16.1	16.0	11.5	17.1
Perth	28.6	16.7	12.5	14.5	15.8	25.0
Hobart	28.6	25.0	25.0	23.1	41.2	27.3
Total	13.1	12.3	10.5	10.9	9.8	16.8

proprietors' funds to finance the working capital necessary to maintain employees' salaries ~%d to meet office and other associated expenses. Proprietors' funds may also have to be drawn upon to meet bad debts and finance slow-paying debtors. But otherwise there is little need for partners' capital.

Clients' funds should be on hand or readily obtainable to pay for the securities they have bought through a broker. The balance sheet of such a firm might show liabilities to other brokers and clients which are large in relation to proprietors' funds, but these items should be approximately balanced by the amounts for debtors (both brokers and clients) and cash on hand and in the bank trust account.

On the other hand, firms which act as dealers and underwriters have a greater need for capital. Funds must be obtained to finance the holdings of securities used for dealing and to take up the commitments arising from underwriting or sub-underwriting. One would expect to find proprietors' funds being drawn upon, at least in part, for these purposes. Also, the dealing function involves a firm in risks which are not inherent in the agency function, for sudden losses can be incurred from changes in the market value of securities held in a dealing portfolio. Thus one would also expect to find proprietors' funds of sufficient size to provide a reserve to meet such losses.

Unfortunately it was not possible to compare the overall proprietorship ratios of firms which act primarily as dealers with those which act primarily as agents, and Table 3-3 therefore shows the recorded aggregate values of proprietors' funds for all the members of each exchange. It is apparent from Table 3-2 that proprietors' funds regularly provide a comparatively small part of the finance used in the conduct of stockbrokers' various activities, and that proprietors' funds were barely able to sustain more than this small proportion when greatly increased finance was needed to deal with the expansion of the business in the share market boom of 1968-70. Only on one occasion did the overall figures for proprietors' funds of the six exchanges amount to more than 13 per cent of the total funds employed by firms. The exception was at June 1971, after a sharp rundown in the scale of the business in the preceding months, when proprietors' funds represented about 17 per cent of funds employed.

In 1969 the Sydney Stock Exchange required its members to show as a separate item in their annual accounts the amounts owing to or by each member's 'immediate family and family companies'. The aggregate amount in this category owing by member firms in June 1969 was about $2 million. The 'immediate family' is defined as one in which the whole of the issued capital is beneficially owned and controlled by a member or his immediate family, or both. In the accounts of several firms, the net amounts owing to the immediate family or family companies were added to the sum of proprietors' funds to give a combined total. However, the totals for proprietors' funds in Table 5-3 were calculated before allowing for the amounts owing to or by the immediate family and family companies.

It will be seen from Table 3-3 that in 1968-69 and 1969-70 there was an appreciable increase in the Sydney figures for proprietors' funds relative to the figures shown for the other exchanges. In the year 1968-69, while the Sydney proprietors' funds rose by about 38 per cent, those for Melbourne fell by about 26 per cent, and there was a significant reduction in the figures for Adelaide, Brisbane and Perth. Over the three years from June 1968 to June 1971 the proprietors' funds shown for the five exchanges other than Sydney fell by $3.1 million (or 15.8 per cent), but Sydney's figure rose by $1.4 million (10 per cent). The main explanation for these differences in recorded trends seems to have been the requirement under Article 89 of the

Sydney Stock Exchange, first introduced in 1969, which had the effect of building up the net capital base of Sydney firms. The rule, which is still in force, requires members to maintain 'liquid capital' in the business of 'not less than $50,000 or 5 per cent of the aggregate indebtedness whichever is the greater'. The purpose is to ensure that at all times member firms maintain sufficient liquid assets to cover their current indebtedness. 'Liquid capital' is defined as 'net worth' less the value of memberships, furniture, fixtures, real estate and other fixed assets, securities which have no ready market, and unsecured loans or advances to a member or partner of a member firm. In calculating 'net worth', all assets are required to be valued at a fair value, but not in excess of the market value. 'Aggregate indebtedness' means the total liabilities of the firm, excluding amounts borrowed on securities owned by the firm, and amounts due to or received from clients and held in the bank trust account.

This net capital rule was introduced following the failure of a Sydney broker (W.L.D. Hewson & Coo) and was adapted from a similar rule of the New York Stock Exchange (since significantly tightened). We have some further comments to make on the failure of this rule to prevent, in New York, the large-scale collapse of broker-dealers during 1969 and 1970, but here we note that in Sydney, unlike New York, there was already in existence in 1969 a rule which required firms to segregate clients' funds and hold them in a bank trust account. This requirement alone, if properly observed, should have been sufficient to ensure that clients' funds were protected in the event of the failure of a Sydney firm. Hence, when the Sydney Exchange took steps to introduce the net capital rule, it would seem that it was concerned to try to avoid general creditors of member firms losing money in the event of a member ceasing business. It may also have been concerned with protecting member firms from each other, for the firm which had failed had been engaged in large dealings on its own account with other members (as well as with clients) and its collapse with a deficiency of about $700,000 had caused losses to these other members on outstanding transactions.

Nevertheless, the net capital rule should also be regarded as an indirect but useful supplement to the bank trust account requirements in protecting clients' funds. Many clients deposit money with broking firms in order to earn interest and these funds are invested by the firms or used in their businesses; they do not have the protection of being retained in the bank trust accounts. With a good monitoring system the regulatory authorities should be able to detect quickly when a deterioration has occurred in a firm's net capital ratio, and this could be one of the first signals of the need for a preliminary investigation of the firm's general affairs. In addition, public investors stand to benefit if brokers feel they can deal more confidently with each other as the result of the existence of the net capital requirements.

Despite the build-up in aggregate proprietors' funds of Sydney members between 1968 and 1969 there was little apparent change in the relationship of these funds to other funds employed by the firms. This may be seen in Table 3-4, which shows for all exchanges the ratios of proprietors' funds to total funds employed. For Sydney members, proprietors' funds were 10.1 per cent of funds employed at 50 June 1968 and 10.4 per cent at 30 June 1969. When interpreting these figures, however, it is to be noted that, in 1969, Sydney members were required to disclose for the first time their gross creditors among their total current liabilities. Previously some firms had shown a net figure for creditors calculated after the deduction of debtors. Thus, between 1968 and 1969, there was, for Sydney firms, a considerable rise in the ratio of proprietors' funds to total funds employed which is not revealed by Table 3-4.

Although, for the reason just mentioned, there are difficulties in comparing the Sydney proprietorship ratios with those of Melbourne before 1968 and 1969, in 1970 and 1971 the two exchanges accounted for creditors in their balance sheets on the same basis. It will be seen that the introduction of the net capital rule in Sydney did not have a noticeable effect in increasing Sydney's ratio relative to Melbourne's, and over the six-year period there was no sustained difference between the ratios of the two exchanges.

However, Table 3-4 shows that the ratios of proprietors' funds to total funds employed for the Sydney and Melbourne Exchanges were considerably lower than those for the other four stock Exchanges. In other words, Sydney and Melbourne firms were relying to a lesser extent on their proprietors' funds in financing their businesses than the firms of other exchanges. The main part of the explanation of this general difference arises from the fact that the nature of the business of the largest firms (those with the largest total assets) in Sydney and Melbourne has been different from that of the largest firms of the other exchanges. In Sydney and Melbourne, the largest firms have been major dealers in securities, particularly government bonds, and they have held large portfolios of these securities partly for dealing purposes. The portfolios have been financed mainly with borrowed funds and deposits, not with proprietors' capital. In this context it should be noted that the net capital rule of the Sydney Exchange - which requires, broadly, that proprietors' funds be maintained at 5 per cent of aggregate indebtedness - may not limit the scope for such activities. Under Article 89 of the Sydney Exchange, 'aggregate indebtedness' is defined to exclude borrowings secured against assets or securities owned by the firm. Individual lenders may insist, of course, that a firm maintain some minimum relationship between proprietors' funds and secured borrowings, and some lenders do require their loans to be secured against government bonds with a market value in excess of

Table 3-5

COMPARISON OF PROPRIETORS' FUNDS WITH TOTAL FUNDS EMPLOYED SIX LARGE SYDNEY AND MELBOURNE FIRMS

	1968		1969		1970		1971	
Firm	Pro-priet ors funds	Total funds emplo yed	Pro-priet ors funds	Total funds emplo yed	Pro-priet ors funds	Total funds emplo yed	Pro-priet ors funds	Total funds emplo yed
	$m	$m	$m	$m	$m	$m	$m	$m
1	3.1	18.3	1.0	16.6	1.9	11.7	1.3	10.1
2	1.1	22.5	1.2	17.8	1.0	18.6	.7	9.4
3	.8	30.7	.8	13.5	.8	18.5	1.0	8.8
4	1.1	11.6	1.5	20.7	2.4	18.6	1.1	3.7
5	1.2	40.0	3.7	62.8	4.2	62.4	2.8	20.9
6	1.9	26.2	3.0	30.6	2.2	24.4	1.0	11.5
Proprietors funds as a percentage of total funds employed:								
1			16.9		6.9		16.2	12.8
2			4.9		6.7		5.3	7.4
3			2.6		5.9		4.3	11.4
4			9.5		7.2		12.9	29.7
5			3.0		5.9		6.7	13.4
6			7.2		9.8		9.0	8.7

the loan. This difference, sometimes known as a 'margin', is regarded by lenders as a provision against a sudden rise in interest rates and a fall in the market value of the bonds. However, some lenders have not required a margin, but have accepted as security bonds with a market value equal to the loan. In consequence, some large Melbourne and Sydney firms have operated with a very high gearing of borrowed funds to proprietors' capital. On the other hand, the major firms of the other exchanges have generally not been engaged in these large-scale bond and money-market dealings.

Examples of the high gearing of six large firms in Sydney and Melbourne which were borrowing large sums to finance their bond holdings at balance dates over the four years 1968 to 1971 are shown in Table 3-5. It will be seen that the proportional relationship between proprietors' funds and total funds employed fluctuated greatly, but that it was not unusual for proprietors' funds to account for less than 7.5 per cent of total funds employed. The proprietors' funds of two firms in June 1968 accounted for only 2.6 per cent and 3 per cent of total funds employed of $30.7 million and $40 million respectively. As the six firms together accounted for a substantial proportion of total funds employed by all Sydney and Melbourne firms (51 per cent in 1968 and 38 per cent in 1971) their high gearing ratios understandably had a marked effect on the ratios for all members of those exchanges.

There is sometimes a considerable extraneous element in the figures recorded for proprietors' funds as at 30 June. This stems from the fact that the profits declared by member firms, like those of other partnerships, are necessarily shown before deductions for income tax; the partnership does not pay or provide for tax, as each of the partners is separately assessed on his total personal income. Hence the figure for proprietors' funds shown at June 50 includes implicit liabilities to the Commissioner for Taxation. Particularly at the end of a year which has been more profitable than the preceding average, the temporarily retained profits of the firms can be abnormally swollen for a period until the partners draw upon the funds to meet their tax and other commitments. It will be seen that the reported figures for proprietors' funds rose at the end of each of the highly profitable years, 1966-67,1967-68,1968-69, and 1969-70, but fell sharply at the end of the last year in the table, 1970-71, when profits took an adverse turn. The contraction in the absolute level of proprietors' funds was particularly marked in Sydney, where the adverse turnaround in trading results was greatest (see Table 3-5).

On the information available, it is not possible to divest the reported figures for proprietors' funds of these transient elements. Another complicating factor is that we came across one case where the partners of a large firm had lodged as security for the firm's bank overdraft negotiable securities valued at between $500,000 and $500,000. The securities remained the property of each respective partner and the transaction was not reflected in an increase in the firm's proprietors' funds. It is possible that other firms followed similar practices. To the extent, however, that a figure of about $35 million as shown in the table for proprietors' funds of the six exchanges in 1968, 1969 and 1971 can be taken as some indication of proprietors' equity interest, it would represent an average of about $200,000 for each of the firms existing in 1968, or an average of about $75,000 per member-partner of all six exchanges. Regarded as personal investments, a figure of this order is considerable.

The partnership character of all member firms of the Australian exchanges, by excluding the injection of public money, does limit their size, and partly explains the growth of family and associated companies which have some advantages, such as limited liability, that partnerships do not have. Nevertheless, by comparison with the shareholders' funds of two other kinds of financial intermediaries, development finance companies and authorised dealers, the absolute volume of proprietors' funds invested in stock exchange firms has been substantial. In the following table the figures for development finance companies and authorised dealers have been taken from the Reserve Bank publication, Flow-of-Funds. The term development finance company is not one commonly referred to in the securities markets and the companies concerned are probably better known as merchant banks.

	Shareholders' funds of:		Proprietors' funds of:
	Development finance companies	Authorised dealers	Stockbrokers
30 June	$m	$m	$m
1966	17.1	13.8	10.7
1967	19.9	17.1	13.5
1968	22.4	17.7	33.9
1969	39.7	21.1	34.2
1970	69.9	19.3	49.4
1971	104.3	23.3	32.3

A particular feature of the table is the rapid and large growth of shareholders' funds of the development finance companies which is an indication of their growing influence in the financial sector. Both development finance companies and authorised dealers operate in the bond and short-term money markets and compete with members of the exchanges in these markets. The development finance companies also act as underwriters and organ-isers of capital issues and provide effective competition for the stock exchange firms in these activities as well. There are many more stock exchange firms than development finance companies and authorised dealers, so that the volume of proprietors' funds invested in most stockbroking firms is far smaller than the shareholders' funds invested in most development finance companies and authorised dealers. However, a relatively small number of the member firms of the stock exchanges account for a sizeable part of the industry's proprietors' funds, and these firms compare in size with many of the development finance companies and authorised dealers. For instance, in Melbourne as at 30 June 1971 there were three firms showing proprietary interests of over $1,000,000 each, and these three aggregated proprietors' funds of $3,506,516, or 30.4 per cent of the total proprietary interests recorded for Melbourne at that date. In Sydney at the same date there were four firms showing proprietors' funds of more than $1,000,000 and they accounted for 38.5 per cent of the Sydney total.

At the other end of the scale, five member firms in Melbourne at 30 June 1971 had negative proprietary interest; that is, the partners owed the firm more than they had invested in it. This negative proprietorship amounted to $382,092. In Sydney at that date there were five firms with negative proprietory interest, totalling $202,462. In Brisbane, two firms had negative proprietorship ($163,685), Hobart had none, and Adelaide had one ($12,686). Some of these firms had operated for several years with negative proprietorship; one Brisbane firm, for example, was in this position for four of the six years of the survey. Two of the firms in Melbourne with negative proprietorship at 30 June 1971 went out of business during the following twelve months. Several stock exchange firms had negative proprietorship for some of the early years of the survey, but built up their capital in subsequent years. One Sydney firm, for example, had negative proprietorship in 1966-67 and 1967-68, but by June 1970 had built up its partners' capital to over $1 million. This remarkable increase in capital came mainly from the profits obtained from underwriting and trading in the shares of speculative exploration companies. By comparison with the profits from these sources, earnings from share agency business were modest. In 1966-67, for instance, gross commissions were $40,000, and in 1969-70 about $340,000.

Table 3-6

BANK OVERDRAFTS OF MEMBER FIRMS
(30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange off:						
Sydney	4,000	3,940	16,343	14,981	22,941	9,091
Melbourne	8,270	11,356	36,031	25,807	26,698	12,711
Adelaide	575	704	2,444	1,270	3,547	1,490
Brisbane	559	877	1,955	1,479	1,590	1,624
Perth	110	326	866	581	720	407
Hobart	76	42	76	175	96	153
Total	13,590	17,245	57,715	44,293	55,592	25,476

Table 5-5 is the first of many to be published in the course of this chapter which point to the preponderant size of the member firms of the Sydney and Melbourne Stock Exchanges in the Australian broking industry. These two exchanges typically account for 80 to 85 per cent of all proprietors' funds in the table. However, a table of proprietary interests is less directly illustrative of the Sydney-Melbourne preponderance of business than some to be given later.

The Roles of Bank Overdrafts and Other Current Liabilities

Although the total of proprietors' interests, including implicit tax liabilities, reached a transient peak at the end of the profitable 1969-70 year, when about $50 million was recorded as being invested in member firms by the partners, the industry has essentially relied on outside sources to provide short-term finance, and also to provide the financial buffer zone that is necessary in an industry characterised by rapid changes in the level of activity. Bank overdrafts were by far the most important source of specifically borrowed funds for the industry during the period of the survey, as shown in Table 5-2. In fact, overdrafts accounted for a considerably higher percentage of the total funds employed than did the proprietors' contribution in all periods except at 50 June 1971. The tables show how sensitively the absolute level of bank accommodation to brokers could respond to differences in the rates of change in the money volume of stock exchange business transacted. In the year ended 50 June 1968, when the increase in Sydney and Melbourne combined stock exchange money turnovers was one of 208 per cent (that is turnovers trebled), compared with an increase of 24 per cent in the previous year, bank overdrafts to members of those two exchanges and to all six exchanges more than trebled over the twelve months. They rose from $17.2 million to $57.7 million for all exchanges (Table 5-6). In the next year, 1968-69, when the rate of increase in the Sydney and Melbourne combined exchange turnovers slowed down to about 16 per cent, the bank overdrafts to members of those two exchanges fell absolutely by nearly $13 million, or 22 per cent.

It will be noted shortly how member firms also, in response to changing turnover volume, greatly varied the mutual giving and taking of credit as between one another, and the similar give-and-take relationships with their clients. Movements in these partly reciprocal credits prevailing inside the investment market greatly exceeded in absolute amount the variations in bank borrowing and in proprietor funds of the brokers. These internal credits and debits were largely self-cancelling and a symptom of long delays in the settlement for buying and selling transactions in a period of unprecedented activity on the exchanges. For the industry as a whole, bank accommodation was much the biggest source of external finance.

A point to note in this context is that the great dependence of stock exchange firms upon bank and other credit can leave the industry peculiarly vulnerable to a sudden tightening of credit and higher interest rates. When interest rates rose sharply during March-April 1970, for instance, even though this followed a long and highly profitable boom, some firms were immediately faced with considerable problems in continuing to finance their own security holdings and commitments arising from underwriting. We were informed of several instances where the firms were forced to seek temporary assistance from strong merchant-banking companies which in turn had access to overseas sources of credit.

As between firms, there were considerable differences in both the extent to which they drew upon bank loans and the uses to which they put these loans. Some of the case studies in this Report relating to the activities of particular firms indicate that bank overdrafts were on occasions financing losses being incurred by the firms concerned, and that it was difficult for the banks to indentify the use to which credit was being put, though the ultimate solvency of the firm would depend on that use. We also received evidence of share traders obtaining credit from member firms, running into many millions of dollars, with the members financing their clients by themselves drawing on their bank overdrafts as well as from finance companies and merchant banking associates. For the industry as a whole, however, the overdrafts had something of the character of a reserve base on which the industry felt able greatly to expand the scale of credit-giving and credit-taking as between member firms and clients and among the members themselves.

The figures in Table 3-6 would appear to show a considerable difference between the practices of Melbourne and Sydney firms as regards the recourse to bank overdraft or differences in the disposition of banks to extend credit to these firms. Throughout the six-year period, the table shows Melbourne firms drawing consistently higher absolute amounts from this source, and sometimes more than twice as much, though Sydney's bank drawings narrowed the gap in the boom year 1969-70. However, the difference is not as general as the total figures for each exchange would suggest. In all years except 1971, the two exchanges would have shown more nearly equivalent overdraft totals if one particular Melbourne firm had been excluded from that exchange's figures.

As a proportion of total funds employed, bank overdrafts varied considerably between the six exchanges. The proportions were generally highest in Melbourne and Adelaide, with ranges over the six years of between 17 and 30 per cent and 18 and 25 per cent respectively. Sydney and Perth generally had the lowest ratios, fluctuating between 7 and 12 per cent in Sydney and between 4 and 14 per cent in Perth. Offsetting these

Table 3-7

CASH ON HAND AND AT BANK BY MEMBER FIRMS
(30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	468	505	2,084	1,498	1,752	1,235
Melbourne	846	1,880	8,873	4,975	7,873	350
Adelaide	147	240	261	384	759	349
Brisbane	47	103	319	336	1,466	196
Perth	33	97	176	271	530	532
Hobart	50	39	114	154	167	17
Total	1,591	2,864	11,827	7,618	12,547	2,679

Table 3-8

OTHER CURRENT LIABILITIES OF MEMBER FIRMS
(Year to 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	26,257	41,700	111,298	156,505	269,523	72,344
Melbourne	28,288	31,091	97,681	61,969	89,824	48,724
Adelaide	1,362	2,587	5,894	4,499	9,163	3,206
Brisbane	934	1,294	7,470	6,954	12,995	4,669
Perth	373	1,625	8,187	4,676	14,216	4,392
Hobart	414	590	845	847	923	632
Total	57,628	78,887	231,375	235,450	396,644	133,967

bank overdrafts to some extent would appear to have been the sums held as 'cash on hand and at bank', shown in Table 3-7. However, the major part of this sum for the years 1966 to 1970 was accounted for by one large Melbourne firm which did not, during that period, list as a separate item in its balance sheet, the funds held in the bank trust account. It showed all deposits at banks under the one heading, 'cash at bank'. Several Sydney firms also followed this practice.

Table 3-8, 'Other current liabilities of member firms', includes amounts owed by member firms to firms on the same exchange and other exchanges (including overseas exchanges). The other largest component is amounts owed by member firms to their clients (an item which includes debts to associated and family companies). Over the six-year period, 'Other current liabilities' accounted for between about 70 and 79 per cent of the funds employed by all firms at 30 June each year (Table 3-2). From the financial statements obtained by the Committee, with their irregular standards of dissection and general presentation, it is scarcely possible to offer a satisfactory breakdown of these components of the firms' liabilities. A fuller dissection, though still not complete, is to be obtained from collating figures for the item 'Debtors' shown on the assets side of member firms' accounts. To some extent, this is the obverse of the same coin: the main components of the debtor balances are amounts owing by other member firms and amounts owing by clients. It is appropriate to tie in a further discussion of the firms' liabilities with a consideration of the figures for their debtor balances, to which we now turn.

Table 3-9

DEBTORS TO MEMBER FIRMS: AMOUNTS AND CATEGORIES
(30 June)
Thousands of dollars

	Class of debtor	1966	196 7	1968	1969	1970	1971
Members of the stock exchange of:							
Sydney	Brokers	3,581	6,383	35,702	52,501	149,992	20,688
	Clients	5,427	13,135	41,312	56,856	97,754	38,386
	Not dissected	2,067	1,355	8,213	1,734		
		Total	11,075	20,873	85,227	111,091 247,746	59,074
Melbourne	Brokers	4,261	7,394	31,167	15,326	23,501	12,511
	Clients	5,177	7,173	34,231	29,028	34,365	32,526
	Not dissected	5,076	4,602	17,763	16,380	29,375	4,873
	Total '	14,514	19,169	83,161	60,734	87,241	49,910
Adelaide	Brokers	453	1,996	4,401	1,319	4,479	1,409
	Clients	1,311	1,424	4,672	3,665	8,227	2,880
	Total	1,764	3,420	9,073	4,984	12,706	4,289
Brisbane	Brokers	593	814	4,569	3,274	1,599	538
	Clients	482	531	1,106	1,767	2,622	4,120
	Not dissected	705	1,151	3,689	2,967	4,197	..
	Total	1,780	2,496	9,364	8,008	8,418	4,658
Perth	Brokers	148	792	1,893	1,639	8,224	1,527
	Clients	207	572	450	3,089	7,401	3,400
	Total	355	1,364	2,343	4,728	15,625	4,927
Hobart	Brokers	20	28	26	13	15	192
	Clients	277	313	678	149	183	97
	Not dissected	28	125	59	687	439	468
	Total	325	466	763	849	637	757
	Brokers	9,056	17,407	77,75	74,07	187,8	36,86

				8	2	10	5
	Clients	12,881	23,148	82,449	94,554	150,552	81,409
	Not dissected	7,876	7,233	29,724	21,768	34,011	5,341
Total six exchanges		29,813	47,788	189,931	190,394	372,373	123,615

Assets of Member Firms

Debtors' Balances

Between 1968 and 1971 debtors were by far the largest item among the assets of brokers (Table 5-2). Of the financial statements we received, the majority, but not all, dissected debtors' balances into amounts owed by other member firms and amounts owed by clients. The members of one exchange, Sydney, gave completely dissected figures for the last two years, 1969-70 and 1970-7 1. Over the six exchanges, the proportion of total debtors' balances which was not so dissected ranged from about 26 per cent in the first year surveyed, 1965-66, to about four per cent in the final year, 1970-71. Table 3-9 presents a summary of the figures obtained from the members of each exchange, with the degree of dissection into broker and client debtors that they permit. The aggregate of debtor balances which were not dissected in the firms' statements are shown in the table as 'Not dissected'.

Another unfortunate complication must be noted in regard to the aggregates for debtor balances. Practice has varied among member firms as to whether they do or do not offset creditors against debtors in the annual balance sheet. Firms who do so offset the balances present merely a net figure for debtors (or creditors) in their accounts. Their figure for debtors and creditors are not comparable with the figures given by the majority of firms which do not follow the offsetting practice. The Sydney Exchange as from the balancing date in June 1969 and the Melbourne Exchange in the following year have brought about uniformity of practice among their members by requesting that creditor and debtor balances are not offset. The number of firms which had previously been offsetting appears to have been appreciable, at least in Sydney, for the Sydney total of debtor balances in the year of adjustment, 1968-69, showed a rise of about 30 per cent when the Melbourne trend was a fall of 27 per cent. A similar discrepancy is to be seen in Table 5-8 between the direction of movement of 'Other current liabilities' for Sydney as compared with all the other exchanges in 1968-69. The effect of these salutary if belated changes in the Sydney and Melbourne practices is to disturb the continuous comparability of these two exchanges' figures in the period covered in the tables.

Subject to the foregoing reservations regarding data in the tables, it will be seen that the totals in Table 3-8 of recorded 'Other current liabilities' consistently exceed the totals for debtors in Table 3-9 by a considerable margin. For the six exchanges, the ratio of debtors to 'Other current liabilities' ranged from as low as 52 per cent at June 1966 to a peak of 94 per cent in June 1970. The more reliable figures for Sydney in the last three years show a similar clear excess of liabilities, but this trend is not found in the figures for Melbourne.

That element of liabilities which consists of amounts owing by member firms to other member firms must approximately equal the corresponding asset element of debts owing to member firms by member firms (subject to any net amounts owing by or to overseas brokers). It does not necessarily follow, however, that there is a regular excess of amounts owing by member firms as a group to their clients over the amounts owed by clients to member firms, and that the lags in settlement work consistently to the brokers' advantage. Differences between the two aggregates may well exist, and some procedural forces bearing on the question will be noted shortly in our discussion of member firms' trust accounts. But the amounts and even the direction of net difference cannot be ascertained from the financial statements. By comparison with the figures for 'Debtors', the item 'Other current liabilities' has a wider and looser connotation. Some member firms formally hold large amounts of money on interest-earning deposit from clients, which would be included in 'Other current liabilities'. Some large firms borrow on occasions from finance companies. Most importantly, some six or seven of Australia's biggest firms continued throughout the six-year period to invest heavily in government securities, raising finance for the purpose in deposits from the money markets and other external sources. The scale and procedures of such dealings will be discussed shortly in connection with the figures in Table 3-10. A large part of the finance obtained for these bond investments is included in 'Other current liabilities'.

The fully dissected figures for Sydney members for the last three years in Table 3-9 indicate that there is no constant relationship between the scale of the internal credit provided mutually among members and the scale of credit which is reciprocally extended between clients as a group and member firms as a group as a result of time lags. Thus, the two categories of debtors to Sydney firms were approximately equal at June 1969; a year later, at the peak of the 1970 share market boom, the debts owed by all brokers to Sydney firms were 53 per cent higher than debts owing by clients of the Sydney firms; but a year later again, in June 1971, when the boom had subsided, the position was reversed, and the debts owing by brokers were little more than half as much as those owed by clients.

With due recognition of the inherent limitations in our data, Tables 5-8 and 5-9 offer striking evidence of the enormous intensification of the process of internal giving and taking of credit in the securities industry that developed in the boom trading years. It is even more noticeable here than in the trends of bank overdrafts that differences in the rate of change in share market turnovers tend to produce magnified absolute changes in the amounts of creditor and debtor balances. Taking debtor balances (Table 5-9) as being the more precisely defined, it will be seen that total debtors rose nearly fourfold, or by

$142 million, in the single year 1967-68 when the money volume of share turnovers trebled. In 1968-69, when the further rise in exchange turnovers was about 15 per cent, debtor balances evidently fell absolutely (perhaps by the order of 24 per cent) after allowance is made for the enlarged basis of the Sydney figures in that year. Then at the end of the boom year 1969-70, in which turnovers had risen by about 50 per cent, the debtors' balances almost doubled (subject to a, possibly moderate, deduction to be made as allowance for Melbourne's introduction of uniform presentation of debts in that year). Part of this leap in debtors' balance, like the one in 1967-68, reflected strains of paper work and growing backlogs in settlements in a period of intense activity. At June 1970, the outstanding debtor balances, $372 million, were more than seven times as great as they had been three years previously. In the final year covered by the table, 1970-71, a 30 per cent reduction in the year's exchange turnovers (most pronounced in the latter months of the year) produced a 66 per cent reduction in the level of debtors, as some backlogs were being overtaken.

As we have noted, these great fluctuations in the debt assets of member firms had their counterpart in the scale of variations in the firms' liabilities to one another and to clients. A process of reciprocal credit giving, though it has been described in some contexts as 'taking in one another's washing', is in itself legitimate, subject to adequate standards of credit control, and is to be seen prevailing elsewhere in overseas share markets. However, the introduction of more efficient techniques of processing share market transactions would result in brokers' current liabilities amongst themselves and to clients being more speedily cancelled by the debts owing to them, though there is a possibility that this might not be a complete offset. The extent of any net differences cannot be calculated from the figures to hand. What becomes obvious from an

Table 3-10

SECURITY BALANCES OF MEMBER FIRMS
(30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	19,109	24,797	28,172	51,096	22,582	13,931
Melbourne	21,302	23,631	39,740	21,219	13,624	7,546
Adelaide	109	147	392	325	674	475
Brisbane	163	174	447	806	1,370	801
Perth	45	26	216	132	309	264
Hobart	11	11	27	10	11	11
Total	40,739	48,786	68,994	73,588	38,570	23,028

examination of the enormous dimensions of the internal credit expansion in the industry is the great importance of the standards of credit control and generally responsible broker behaviour in periods of wide fluctuation, given the limited scope for expansion of the base of proprietors' funds to meet all the additional contingencies. Bank overdrafts have hitherto been the principal means for expanding that base.

Holdings of Securities

A far more significant, and a little known major asset of some firms has been their holding of securities. As a proportion of the total assets of all member firms of the exchanges at 30 June each year, this item in Table 3-2 (referred to as 'Security balances') fluctuated from a high of 49.7 per cent in 1966 to a low of 7.7 per cent in 1970. Table 3-10 giving the aggregate figures and yearly movements of this item, shows how these holdings were not less than $38 million on any of the five balancing dates of 1966 to 1970 and were as high as $73 million in June 1969. The securities include ordinary shares, debentures and governmental securities. In one instance a firm also held commercial bills to the extent of about $1 million. The ordinary shares are sometimes held for long-term investment, as well as for dealing purposes, an activity often referred to as 'house trading'. All the securities are commonly grouped together in the firms' financial statements under such headings as 'investments' or 'stocks on hand', so that a dissection of the aggregates cannot be made. There are also differences in the basis of valuation of the securities. Some firms value consistently 'at market' prices ruling on the balancing date, others 'at cost', and many do not state their method of valuing. The Sydney and Melbourne Stock Exchanges have now laid down a general guideline prescribing the use of 'the lower of cost or market valuation', but among the other exchanges it is not clear what practices prevail.

However, there is no doubt that the bulk of these recorded holdings of securities consisted of governmental paper, and that the bonds were held almost entirely by a few of the biggest firms in Sydney and Melbourne. This can be said because the firms in question gave figures for their holdings of bonds in their annual accounts. Thus, at the high point of June 1969 in the table, four Sydney firms accounted for $47.5 million of the total of $51 million of securities shown for that exchange, and most of their holdings were in government and semi-government bonds. One firm alone held $20 million of bonds at that date. Similarly in Melbourne, the three largest firms held 92 per cent of all the securities listed for that exchange on the three balance dates of 30 June 1966, 1967 and 1968, and these were mainly holdings of government bonds. The smallness of the residue of company shares held directly by member firms of the stock exchanges is consistent with the fact previously mentioned that much of the members' share-trading activities has been conducted through associated companies. In addition, some firms which have engaged in a large volume of share-trading have followed the practice of holding the shares they have bought for only short periods, so that there has been an exceedingly high turnover of their stocks in the course of, say, a year.

The policy of maintaining very large investments in bonds that is pursued by six or seven of the country's major stock exchange partnerships has an extraneous aspect. Such investment is hardly a part of sharebroking business proper, and it entails the partnerships in raising correspondingly large amounts of borrowed funds, usually on a short-term basis to finance the holdings. On occasion, for example, we have found a single firm borrowing $52 million on deposit (approximately half secured and half unsecured), mainly to accommodate its bond investments. The greater part of these large borrowings is usually drawn from the various institutional and corporate lenders in the money markets, as well as from companies with which the member firms may have associations. The deposits are usually obtained at short-term rates which allow a margin of profit from the bond interest rate received, sometimes with additional taxation advantages. The lenders generally have security in the bonds, possibly including registered ownership of them, though the arrangements provide that the stockbroking firm takes the profit or loss arising from changes in the market value of the securities. Some of these arrangements are of a kind technically known as 'buy-back' or 're-purchase agreements'.

That substantial capital losses may be incurred from this bond dealing may be seen from the records of three firms. In one case the firm's bond-trading loss was about $1 million over the two years ended in June 1970 ($800,000 in 1969, and $200,000 in 1970). The fact that the firm still showed a profit of about $1.2 million over this period was mainly as the result of the large commission earnings obtained from the booming share market. In the second case, bond-trading losses were about $900,000 over the two years to June 1970. Again, earnings from other sources were more than sufficient to offset these losses and show a profit of over $3 million during the two years. The third firm's bond-trading loss during the two years to June 1970 was about $2 million, but again other earnings were sufficient to result in a final profit of about $1.9 million for the period. In 1971, however, this firm made a total loss of about $1.5 million, and one of the main factors leading to this result was the bond-trading loss of over $1 million. A substantial part of these large bond-trading losses appears to have resulted from the increase in interest rates in 1969 and 1970 and the corresponding fall in the market value of the securities.

The foregoing figures illustrate the risks involved in dealing activities which are not inherent in the agency function of stock exchange firms. As it happens, the losses were more than offset by the profits from other aspects of the firm's businesses, and particularly by the rising brokerage commissions received during a period when the share market was booming. But if there had not been these other sources of revenue, the losses would have had to be borne by the partners and they would have markedly reduced proprietors' funds. In the earlier discussion of 'Proprietors' funds of the partnerships' we have referred to the very low ratios of proprietors' funds to total funds employed by some of these bond-dealing firms. We recognise that the partners would have had assets which were not invested in the firms, but we have no way of knowing how substantial these were.

The extraneous-looking practice of large-scale bond dealing by certain member firms of the stock exchanges is a survival from times before the emergence of today's more specialised operators in the bond and money markets. The origins of today's bond and money markets lie to a large extent in just such activities of stock exchange firms as we have outlined. These firms then proceeded to play a leading part in the formation of the specialised bond and money market companies, nine of which have credit facilities with the Reserve Bank and are known as authorised dealers. What is not commonly known is that, although stock exchange firms sponsored such companies a decade ago and retain strong affiliations with some of them, several firms themselves have continued into the early 1970s to operate in government securities on a big scale, sometimes drawing on their associated companies and affiliated merchant bank companies for the finance to do so. Taxation considerations have evidently played a part in some of the brokers' bond dealings. In our later discussion of Minsec we mention a typical example of the practice known as 'bond washing' in which a broking firm took ownership of about 26 million worth of government bonds for a period of about four weeks in order to receive the interest which carried tax rebates. But some big brokers have remained active in bond dealings on a more continuous basis and with other objectives than tax minimisation.

From the above discussion of processes behind the large figures for brokers' holdings of securities it will be apparent that the corresponding deposit taking or borrowing arrangements constitute an appreciable and variable element of the item 'Other current liabilities' (Table 3-8) which we have considered earlier. Because of differing accountancy practices among brokers, it is an element that cannot be exactly quantified.

Members' Bank Trust Accounts

Troublesome questions continued to arise throughout our inquiries concerning the maintenance of members' bank trust accounts. We received evidence that, despite the existence of rules and laws requiring the maintenance of such trust accounts, they have often not been properly kept, and that they are peculiarly liable to be allowed to run down when a firm encounters financial difficulties, with disastrous consequences for clients if the firm fails. For example, of the six stock exchange firms which failed in Melbourne during the period of our inquiries (one as recently as August 1972) four showed deficiencies in their trust accounts totalling over $1.5 million. In no case, at least to the Committees' knowledge, were any of these deficiencies in trust funds discovered by any authority before the broking firm had failed - that is, before it was too late to warn or protect the interests of investors. The legal status of these trust accounts as to their creditor ranking is another matter of doubt and concern. There is also some difficulty in defining what is a deficiency in the trust account.

In this section, our principal objective is to refer to some of the procedures in the keeping of the bank trust accounts run by stock exchange firms and to record the available figures with some expository comment on their meaning. In the next section we refer to some of the recent changes in the United States concerning the segregation of clients' funds.

The rules of most Australian stock exchanges have, for many years, provided for the keeping of what are called 'members' trust accounts'. In Sydney, for instance, each member has been required by the exchange to maintain a 'trust account' at a bank into which is paid 'within three business days' money received from clients for the purchase of securities if this money is received before the member is required to pay for the securities purchased. A member must also pay into this trust account the funds received from the sale of a client's securities unless these funds are paid to the client within three business days after their receipt. The rules provide for the deduction of commission and other charges owing to the broker before these payments are made into the trust account, and the circumstances in which the funds may be withdrawn from the trust account are also set out in the rules.

The objective of these rules of the various exchanges has been to try to ensure that clients' funds are kept separate and intact in the event of a firm's insolvency. In our view, the rules concerning the keeping of bank trust accounts are particularly important in Australia where many stock exchange firms engage in their own dealing as principals, thereby running risks which are not incurred in conducting agency business. If these firms were not required to segregate their clients' funds in a separate bank account, they could readily use the cash to finance their own principal positions as either a dealer or an investor. Should such a firm incur a crippling loss from its own dealing which caused it to default, clients' funds could be lost and the clients concerned put in the position of being general creditors of the firm.

A somewhat surprising feature of the accounts of Australian stockbrokers is that these firms regularly list the bank trust account balances as assets in their own balance sheet~ In Table 5-2 this item is shown as accounting for between 5.6 per cent and 7.2 per cent of the total assets over the six-year period. 'It is also paradoxical to report that although these bank trust account balances appear regularly on the assets side of the firms' balance sheets, they are rarely specified as a liability to clients in the same balance sheets. In order to understand these features of the financial statements, inquiries were carried out into the procedures in several brokers' offices, and a simple example of what appears to be a fairly common accounting practice will show how these cash balances come to be included as assets but are not listed separately as liabilities to clients.

When broker A buys shares for a client from broker B, he generally records the transaction by debiting the client in a clients' ledger with the cost of the shares and crediting broker B in a brokers' ledger. If the client pays for the shares before broker A has received delivery of the scrip from broker B, the funds are paid into the bank trust account (in some circumstances this would be after an interval of three days, see below) and the client's account within the clients' ledger is credited. At this stage, the liability in broker A's accounts which balances the entry in his bank trust account is the amount he owes broker B in the brokers' ledger. (If the shares had been bought from another client instead of from broker B, the corresponding

Table 3-11

BANK TRUST ACCOUNTS AS ASSETS OF MEMBER FIRMS
(at 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	1,082	1,246	9,450	8,168	16,566	5,967
Melbourne	1,638	2,410	8,387	9,824	18,660	7,178
Adelaide	14	30	107	134	211	323
Brisbane*						101
Perth	29	27	478	166	272	126
Hobart	18	34	24	27	30	94
Total	2,781	3,747	18,446	18,319	35,739	13,789

** Not required to be maintained 1966 to 1970.*

liability would be the amount owed to this other client in the clients' ledger.) In other words, from the point of view of someone scrutinising broker A's balance sheet at this point in time, the funds in the bank trust account are shown as an asset of the broking firm and the balancing liability is not to the client whose money has been paid into trust, but to another broker (or to a client from whom the shares had been bought). There are circumstances when a different relationship applies. For example, in the case where broker A has sold shares on behalf of a client and is holding the funds obtained from the sale in the bank trust account, the balancing liability in the balance sheet is to the client.

In aggregate terms, therefore, the liabilities offsetting the figures in Table 5-11 ('Bank trust accounts as assets of member firms') are included in Table 3-8 ('Other current liabilities of member firms'). To continue with the example given: the occasion when the funds in broker A's bank trust account should be withdrawn and paid into his general bank account is when broker B delivers the shares bought by broker A on behalf of the client. In exchange for the scrip, broker A would pay broker B with a cheque drawn on his general bank account.

This example of a common practice shows that although a client's funds are physically segregated from a firm's other funds, the accounting records of the bank trust account form an integrated part of the accounting records of the member firm's business. There is no separate accounting system with a trust account ledger covering the movement of the client's funds into and out of the bank trust account. The explanation we have received from brokers with whom we discussed these matters is in terms of the necessities of office procedure. In view of the large number of individual buying and selling transactions for many clients and the delays in delivery of the scrip (or of all the scrip involved in one particular transaction), it is thought to be impracticable to keep a separate and more detailed record of the trust account entries made on behalf of individual clients. We even came across several broking firms which found the administrative problems of maintaining daily records of the bank trust account so difficult during the mineral share boom, that they simply paid a lump sum into the account and left it there for as long as they thought it was of sufficient size to meet their obligations to clients. In this respect it must be recognised that the organisational problems faced by a busy broker in maintaining a trust account are considerably different from those of a solicitor or a real estate agent. Whereas, say, a medium-sized busy broker may be called upon to process more than a hundred trust account transactions during a day, a medium-sized busy solicitor may handle about fifty such cash transactions.

Having said that, however, we must also report that, in our own experience, when the bank trust account records are integrated with the firm's general accounting procedures, there can be considerable difficulty in tracing and investigating the past movement of funds into and out of the account on behalf of individual clients. In some cases we found it was not possible to trace in the accounting records the withdrawal of particular funds on behalf of a client. In order to examine such transactions it was necessary to call for other documents and memoranda prepared at the time, and these were not always available. Auditors have also informed us that although there is usually little difficulty in auditing the current position of the bank trust account run along the lines we have described, provided the records are properly kept and up-to-date, the inspection of old entries can present considerable difficulties. As one auditor said, special care has to be taken with brokers' trust accounts to see that the accounting records provide an 'audit trail'. Another auditor informed us that in the case of several firms which had failed there were 'some quite major problems ... in determining whether a deficiency [was] in the trust account or in the ordinary account'.

There has been some questioning as to whether the term 'trust account' should strictly be applied to money balances held in segregated bank accounts by stock exchange firms. In one essential respect, however, the balances may be directly compared with solicitors' trust funds. A purchasing client of a broker usually (unless he belongs to the privileged class of client who pays only on delivery of scrip) pays for the stock bought on his behalf before the broker is in a position to effect delivery of the scrip. The money is in that sense being held by the broker on trust, as a solicitor holds money on trust in conveyancing transactions. The period of the clients' prepayment for scrip may run into several weeks. In times of intense share market activity, involving abnormally long lags of many months in the delivery and office handling of documents, the size of the funds thus held from purchaser clients can rise at exponential rates.

In respect of Table 5-11, the figures relate only to the asset item listed in member firms' balance sheets at 30 June each year. We must also draw attention to the fact that during the six years covered by the table the requirements concerning the keeping of trust accounts were not uniform as between the various exchanges, some being considerably more relaxed in their definitions and procedures than those which have so far been described. In respect of Brisbane, for example, the table records no figures at all for the first five years. Not till the Securities Industry Act was introduced in Queensland in 1971 were brokers in that State required to segregate their clients' funds in bank trust accounts. Also, as we have already said, for some years several Melbourne and Sydney brokers showed the funds they held in bank trust accounts under the heading 'cash at bank' and it has not been possible to separate these amounts from the totals in Table 3-7.

It should be noted, incidentally, that for the years covered in Table 3-11 all firms were allowed a three-day period of grace under stock exchange regulations between their receiving money from purchaser clients and transferring the money from the firm's general bank account to the trust account. After this permitted time interval had been criticised in the course of a judgement delivered in the Supreme Court of New South Wales in 1971, one exchange, Melbourne, reduced the prescribed maximum interval to one day.

Subject to their considerable inherent limitations, as described, the figures in Table 3-11 afford some indication of the great and rapid changes in trust account responsibilities that may occur in the broking industry. Because these variations in trust funds are a function not only of the volume of stock exchange turnovers but also of delays in documentary processing, this is one of several items in the firms' balance sheets that we have had occasion to notice as fluctuating more extremely than the turnover volumes. Thus, in the single year ended June 1968, when turnovers trebled, the balances in bank trust accounts at 30 June rose almost eightfold in Sydney and more than threefold for the five exchanges from which figures are available. A 30 per cent fall in turnovers in 1970-71 brought a 61 per cent reduction in the balances of the five exchanges (excluding Brisbane's figure). Generally speaking, the bank trust account balances of the Melbourne and Sydney firms again dominate the Australia-wide figures in the table.

In concluding this exposition, we may observe the relevance of the procedures to a question which has been noted earlier in the chapter as to the relationship existing between the amounts which brokers as a whole owe to clients and the amounts owing to brokers from clients. We have seen how a purchasing client is usually required to pay for shares upon receipt of his broker's contract note covering the transaction, and well before he receives the scrip that he ordered. His broker, whom we may call A, does not have to make payment to the broker, B, who acted for the seller of the shares until broker B delivers the scrip to broker A. Meanwhile, the purchasing broker has a net accession of funds from his client. On the other hand, broker B is not expected to pay his selling client until he receives the client's scrip. He should then make prompt payment for the shares, but a procedure also exists for daily settlements between brokers upon the mutual exchange of scrip, so that broker B should not be as long 'out of pocket' after settling with his client as broker A has been 'in pocket' from the advance payment for scrip made by his client. On balance, the broking industry would be continuously 'in funds' from its dealings with clients - were it not for the requirement that the advance payments of purchaser clients should be lodged in separate trust accounts with the banks. The three-day period of grace before lodgment still appears to have permitted a degree of net funding of brokers by clients. Subject to that, the bank trust account requirement as applied on some exchanges has an equalising function among the procedures laid down for broker-client payments. Some exchanges also require that any bank interest obtained from trust account deposits should not accure to the broker but be paid into the exchange's 'fidelity fund' as a reserve for the relief of clients who may be the victims of a member firm's defalcations.

Segregation of Clients' Funds in the United States

We have referred to the dangers of brokers who do not keep their clients' funds in segregated bank accounts using these funds for their own dealings. That this can be a serious problem was brought home by the experience of the New York Stock Exchange during the late 1960s. Members of the New York Stock Exchange had not been required to segregate their clients' funds into special bank accounts and, in consequence, it was customary for members to use these funds extensively to finance their own activities, including their dealing positions. By using clients' funds in their businesses, many firms (known as 'broker-dealers') apparently operated with limited proprietors' funds (or shareholders' funds, as some of the members were incorporated) and, by comparison with Australian firms, made relatively little use of bank loans. (See, Securities Industry Study, Report of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, House of Representatives, Washington, 1972). The collapse of many New York firms during 1969 and 1970, with extremely large and widespread losses, led to several official investigations, and one of the main findings was that broker-dealers can transmit large losses to their clients if they use their clients' funds to finance their own dealing. (See, Securities Industry Study; also The Financial Condition of Broker-Dealers: A Question of Adequate of Capital and Regulator Standards, Office of Policy Research, Securities and Exchange Commission, June 1971.)

Although New York firms were not required to segregate clients' funds, they were required to maintain certain net capital ratios. However, as one report said: 'The experience of the past couple of years [1969 and 1970] suggests that net capital requirements, while providing an incentive to maintenance of financial responsibility sufficient to ward off a disaster, are not sufficiently protective of customer funds and securities'. It was pointed out, that the requirement of the New York Stock Exchange that brokerage firms maintain their net capital at not less than 5 per cent of aggregate indebtedness in effect permitted the firms to borrow clients' funds and securities on a margin of 5 per cent (The Financial Condition of Broker-Dealers, p. 64).

As a result of the financial crisis in the United States securities industry, the Congress introduced legislation in 1970 providing that brokers and dealers may not use clients' funds and securities in violation of rules adopted by the SEC. Previously the SEC had no general rules regarding the segregation of clients' funds and securities. The rules subsequently adopted, and some currently proposed, deal with net capital ratios of brokers and dealers and the segregation and protection of customers' securities, as well as with clients' funds. What is broadly required with respect to clients' funds is that brokers and dealers maintain a segregated bank account known as a 'reserve bank account' when using these funds. Under a formula for determination of the reserve requirement, a number of items are classified as clients' credits and a number as clients' debits. An amount equal to the excess of credits over debits must be on deposit in the reserve bank account. Computations of this sum must be made weekly, as of the last business day of the week, and the bank deposit must be made by a stipulated hour after that. If the broker or dealer fails to make a required deposit on time, he must by telegram immediately notify the SEC and some other authorities. These requirements are subject to exceptions which allow a monthly computation where the net capital ratio of the broker-dealer is very favourable and the aggregate amount of clients' funds less than an absolute figure ($US1 million). There are also various exceptions in circumstances where the activities of the firms are severely~ restricted both as dealers and as agents (see SEC Rule 15c 3'3 made under the Securities Exchange Act 1934). Funds in the reserve bank account are deemed to be specifically identifiable property of the protected clients. They are protected in the event of the broker or dealer becoming insolvent. To the extent that the specifically identifiable property is not sufficient to satisfy all their claims, the property is divided pro rata among them. There is other recourse under the Securities Investor Protection Act of 1970.

It should be recognised that the Australian stock exchanges have been well ahead of their United States counterparts in accepting the principle that clients' funds should be segregated from the firms' own funds. The weakness with the Australian exchanges has been in the inadequate supervision of their rules, and perhaps in recognising the need to devise accountancy systems which safeguard clients' funds while also allowing for the development of efficient techniques of processing many individual transactions. In the United States, the regulations appear to be more flexible than in Australia in allowing for the bulk segregation of funds and securities and in relaxing the regulations where a firm limits its own activities as a dealer.

Deposits and Other Assets

During the survey period, this item accounted for between about 4.1 per cent and 11.8 per cent of total assets of all stock exchange firms. Various types of assets have been included in the total, the main ones being deposits, trade debtors, stock exchange seats, goodwill and prepayments. Once again, there has been no uniformity in the treatment of these various assets, and in many balance sheets they do not appear at all. Deposits have been the single largest item in the total, but this arises from the large holdings of a relatively small number of firms. In 1970, for instance, one firm held $16 million in deposits. As this firm was also a major borrower of short-term funds, the $16 million on deposit may have been regarded as a pool of liquidity to meet withdrawals. Alternatively, the $16 million may have been held on deposit temporarily before being invested in other assets, such as government bonds. Although most balance sheets did not disclose with whom deposits were held, it is known that large broking firms have associated merchant-banking, finance and bill-dealing companies with which they have held deposits from time to time.

Several firms held substantial amounts (ranging from $1 million to $3 million) under the heading 'Trade debtors and prepayments'. A small number of firms also had a 'goodwill' item among their assets, and in one case this was over $600,000. We are unable to explain the circumstances in which these various amounts came to be recorded as assets. 'Stock exchange seats' regularly appeared in the balance sheets of about 19 Sydney firms, and in 1970 and 1971 the aggregate value of this item for the Sydney Exchange was nearly $1 million. About twelve Melbourne firms also recorded figures for stock exchange seats through to 1970, and in June 1970 the aggregate value for this item was about $300,000o In 1971, however, only four Melbourne firms followed this practice.

Fixed Assets

For various reasons, member firms of the stock exchange do not invest much in fixed assets, and it is rare to find a firm occupying premises which are its freehold property. Being unincorporated they do not in practice raise public capital, and they generally find it difficult to borrow long-term fixed interest funds from financial institutions. Although member firms borrow extensively and continuously from trading banks,

Table 3-12

FIXED ASSETS OF MEMBER FIRMS
(Year to 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	776	640	855	1,054	1,695	1,939
Melbourne	906	842	1,094	1,831	2,488	2,939
Adelaide	106	115	144	317	1,004	358
Brisbane	186	168	232	458	384	361
Perth	80	81	103	167	181	200
Hobart	41	38	43	66	85	66
Total	2,095	1,884	2,471	3,893	5,837	5,863

these funds are generally used to finance day-to-day business activities and debtors, and are not regarded as being available for, say, the purchase of a city building. In addition, as we have seen, the volume of business conducted fluctuates greatly within short periods, so that the firms cannot be sure that their own staff and office space requirements will grow steadily from year to year, as happens with many other financial groups. So as to maintain their profitability during business downswings it is generally necessary for brokers to cut their overhead expenses quickly, which usually means releasing staff, and perhaps vacating office space. Many members believe that they can adjust to these changes with greater flexibility by renting additional office space during the periods when it is needed. Also, many brokers have limited staff and office space requirements by comparison with some other financial intermediaries and institutions.

In the course of our inquiries, we encountered the odd instance where a firm included other forms of real property such as houses and even paintings among the assets in its balance sheet. The frequency of such instances cannot be determined from the financial statements available to us. Table 3-12 shows aggregates for fixed assets, arranged according to membership of each exchange. The fixed assets include motor vehicles and office furniture and equipment, among other items. While the total book value of fixed assets almost trebled over the period (rising from $2.1 million to $5.9 million, the rise being most marked in Melbourne), fixed assets were still at about the same low proportion of three per cent of brokers' total assets at the end of the six years (Table 3-2). In the contracting business circumstances of 197o-71, the stated values for fixed assets still rose substantially in Sydney and Melbourne, though they fell in three of the other four exchanges. A consequence of the low level of fixed assets in the broking industry is a corresponding lack of traditional forms of security as a basis for raising finance of a medium to long-term character.

Profitability of Member Firms, 1966-71

In calculating the profits of stock exchange firms included in our survey we have added back to profits the salaries which a varying number of firms paid to equity partners and the interest which some firms charged on proprietors' funds. The records received by the Committee showed that between 1965-66 and 1968-69 the number of firms which paid salaries to equity partners fluctuated between 22 and 25. In 1969-70 the number increased to 30, but fell to 12 in 1970-71. The total of such payments over the six-year period was about $5.4 million. To some extent this sum is an underestimate of the salaries paid to equity partners, for several firms paid these salaries but did not disclose the precise amounts, or did not disclose the amounts for some of the years in which the payments were made. A smaller number of firms deducted as an expense an interest item on proprietors' funds. Between 1965-66 and 1969-70 the number of firms in this category increased from 12 to 19, but fell to 4 in 1970-71. The total amount of such deductions over the six years was about $ 1.2 million.

Table 3-13 shows that the declared profits, as defined (subject to tax) of all member firms on the six metropolitan stock exchanges over the six-year period ended June 1971 amounted to $107.5 million. That aggregate would be equivalent to an average pre-tax figure of about $40,000 a year to each stock exchange seat existing at the end of the six-year period. If it is also assumed that the proprietors' funds invested in the firms in June 1971 had been invested throughout the six-year period, the average proprietors' funds invested per stock exchange seat would have been about $73,000 a year. A notional charge against profits based upon this capital earning a 10 per cent rate of interest would reduce the annual pre-tax profit per stock

Table 3-13

PROFITS OF MEMBER FIRMS
(Subject to tax on partners)
(Year to 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	1,990	3,082	12,091	11,548	14,511	(-1,892)
Melbourne	2,151	4,327	14,029	10,089	12,476	1,975
Adelaide	360	613	1,888	1,745	2,599	207
Brisbane	177	511	2,267	1,822	1,408	(-114)
Perth	199	329	1,459	971	3,299	41
Hobart	97	111	273	245	396	170
Total	4,974	8,973	32,007	26,420	34,689	387

NOTE: Salaries paid to the firms partners (amounting to $5.4 million over the six years) and treated as an expense and interest charged on proprietors' capital (amounting to $1.3 million over the six years) have been added back to profits. See text. The losses of firms which went into liquidation and ceased to be members of an exchange in 1970-71 have been excluded from that year's results.

Table 3-14

PROFITABILITY RATIOS: PRE-TAX PROFITS TO AVERAGE* PROPRIETORS' FUNDS
(Year to 30 June)

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
	per cent	per cent	per cent	per cent	per cent	per cent
Sydney	47.5	66.9	124.5	67.5	60.8	(-8.6)
Melbourne	44.8	77.5	137.5	82.6	103.0	15.6
Adelaid	71.7	107.4	138.5	108.5	153.2	10.4

e						
Brisbane	21.3	61.5	170.5	105.3	80.5	(-7.2)
Perth	115.0	110.8	170.4	89.0	178.1	1.9
Hobart	47.5	53.4	105.8	76.8	74.6	32.0
Total	46.5	74.2	134.9	77.5	82.9	.9

**Average of the balances at beginning and close of the financial year, except for 1966, when the figures are the closing balances (See Table 3-3). Pre-tax profits from Table 3-13.*

exchange seat to $32,700.

Over the six years, the Sydney and Melbourne firms, as groups, earned respectively $41.3 million (representing an average of about $53,800 a year per seat before a notional interest charge) and $45 million ($46,900 a year per seat before a notional interest charge). Together, Sydney and Melbourne accounted for 80 per cent of the disclosed profits from all exchanges. The figures do not, of course, include the results of share-trading companies owned by the partners of broking firms and sometimes conducted in conjunction with their broking activities. Profits of these companies are directly taxable, but the taxation of profits earned by broking firms is met individually by the partners as part of their total assessable incomes. Table 3-13 also excludes the results of any share-trading carried out by the partners in their individual accounts as distinct from their firms ' accounts.

Taken as they are, the figures show great fluctuations of profit over the period, ranging from a rise of 257 per cent in 1967-68 to a fall of 99 per cent in 1970-71. The great bulk of the aggregate profit was recorded in three years of exceptionally heavy speculative trading activity, 1967-68, 1968-69 and 1969-70. Although the last year of the table, 1970-71, was also one of very big turnover volume, exceeding in that regard all but one of the three highly profitable years, nevertheless the overall profits of the exchanges fell to a mere $387,000, and two exchanges recorded aggregate losses for their firms. A considerable backlog of paper work overhanging from the previous boom trading years left a carryover of office expenses in 1970-71, not matched by revenue from many of the overhanging transactions. Moreover, bad debts arising from business which had been conducted in the boom years, and treated as profitable, were sometimes not taken into account until a later period. For these reasons, the declared profit figures for the last two or three years shown in the table, are best considered in conjunction. It will be seen shortly that losses incurred by broking firms on their own share-trading and bond-dealing activities also played a considerable part in bringing about the adverse turn in the overall results for 1970-71. According to the available figures, each of the exchanges' aggregate results from share-trading were, without exception, loss results in that year.

After Melbourne and Sydney, the order of aggregate profitability of the other exchanges in the six years was: Adelaide, Perth, Brisbane, Hobart. The first three of these were fairly comparable with one another in performance. Hobart is distinctly smaller, and some brokers in Tasmania record items of income sources such as rent and agency fees which are extraneous to sharebroking.

In Table 3-14 we have compared the profitability ratios (pre-tax), computed by dividing declared profits by average proprietors' funds, of the six exchanges over the six years of the survey. The first year of the table, 1965-66, was one of moderate growth in the economy, and brokers' profits were not yet affected by the boom in mining and oil share-trading. The ratios varied greatly between a low of 21.3 per cent for Brisbane to 115 per cent for Perth, and averaged 46.5 per cent for all exchanges. Because of the absence of information relating to the results of the brokers' associated proprietary companies it is not possible to determine which were the most profitable exchanges in the broadest sense. In general, however, the profitability ratios increased substantially in subsequent years, rising to a peak of 134.9 per cent in 1968, until the year of heavy adjustment, 1970-71.

Particular care needs to be taken when interpreting these ratios owing to the fact that charges have not been made for the salaries of equity partners before calculating the firms'

Table 3-15

PROFITABILITY OF SIX LARGE FIRMS

Years ended 30 June	1966	1967	1968	1969	1970	1971
	$ '000	$ '000	$ '000	$ '000	$ '000	$ '000
Three Melbourne firms						
Pre-tax profits	903	1,769	5,024	3,276	3,039	1,597
Partners' salaries paid	231	240	345	389	594	614
Pre-tax profits after partners' salaries	672	1,529	4,679	2,887	2,445	983
Average proprietors' funds[1]	1,953	2,2 10	3,753	4,014	3,384	3,407
Pre-tax profits after partners' salaries as percentage of average proprietors' funds	34.4	69.2	124.7	71.9	72.2	28.9
Three Sydney firms						
Pre-tax profits (loss)	578	1,504	4,222	3,510	3,383	(-1,702)
Partners' salaries, notional[2]	147	205	290	417	661	..
Pre-tax profits (loss)	431	1,299	3,932	3,093	2,722	..

after partners' salaries						
Average proprietors' funds[1]	1,006	1,248	3,028	6,306	8,515	6,861
Pre-tax profits after partners' salaries as percentage of average proprietors' funds	42.8	104.1	129.9	49.0	32.0	..

1 The average of the balances outstanding at the beginning and close of the financial year, except for 1966, when the figures are the closing balances.

2 As these Sydney firms did not pay partners' salaries, an allowance has been made for this expense. The notional salaries have been calculated to bear the same relationship to pre-tax profits as they do with the three Melbourne firms.

Table 3-16

REVENUES OF MEMBERSHIP FIRMS
(Year to 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	7,565	8,994	24,221	30,872	52,032	31,571
Melbourne	10,360	13,967	32,400	32,852	44,093	29,077
Adelaide	957	1,319	3,290	3,249	5,621	4,913
Brisbane	1,158	1,465	4,278	4,565	5,883	3,000
Perth	459	650	2,400	2,235	6,171	3,201
Hobart	254	281	495	487	767	345
Total	20,753	26,676	67,084	74,260	114,567	72,107

NOTE: Revenues were obtained mainly from brokerage fees, commission on underwriting and subunderwriting, share and bond dealing as principals, interest, dividends and management fees.

3.55

profits. Such a charge should be made before these rates of return on capital invested in stock exchange business are compared with the rates of return on capital invested in other business in Australia.

One of the exercises carried out by the Committee was to make an assessment of the profitability of six large Sydney and Melbourne firms after providing for salary payments to partners. The proprietors' funds of these firms accounted for between 25 per cent and 33 per cent of the proprietors' funds of all stock exchange firms at balance dates during the years of the survey. Two of the Melbourne firms disclosed their salaries to partners for each of the six years, while the third firm disclosed the payments for every year except 1970-71. We therefore assumed the 1970-71 figure was the same as for 1969-70. None of the three Sydney firms made salary payments to equity partners, so notional salaries were calculated on the basis that these had the same relationship to net profit as did the partners' salaries of the Melbourne firms. The results are in Table 3-15. It will be apparent that in Melbourne the rates of return on the substantial sums invested in the businesses were very high indeed by general business standards, reaching 124.7 per cent in 1967-68, the exceptional year of the boom. In the pre-boom year, 1965-66, the return was 34.4 per cent, and in the year of the downturn, 1970-71, the return was still 28.9 per cent. The Sydney rates of return between 1965-66 and 1969-70 were also at remarkably high levels by general business standards, rising to 129.9 per cent in 1967-68. In 1970-71, one of the Sydney firms made a small profit, but the other two made losses. The combined result for the three firms was a loss of about $1.7 million before the payment of partners' salaries. However, in that particular year, the loss of $1.7 million was accounted for mainly by the firms' own activities as share and bond dealers; for three of the firms made losses on bond dealing totalling over $2 million, and two of the firms made share-trading losses of $1.2 million.

It was not possible to segregate the agency business of these Melbourne and Sydney firms from their other activities and analyse the rates of return on the capital invested in this agency business. But the large losses incurred by the Sydney firms from bond dealing for part of the period, and their further losses from both bond dealing and share-trading in 1970-71, suggest that with these firms the commission earnings from broking made the main contribution to profit. We have already noted that generally a firm needs a smaller volume of proprietors' funds to conduct an agency business than it does to conduct principal dealings. Thus a significant part of the proprietors' funds and total expenses of the largest Sydney firms should be apportioned to the firms' activities as dealers. If it had been possible to prepare the tables in this way, the rate of return on proprietors' funds invested in the agency business might have been considerably higher than the rates of return on proprietors' funds invested in the business as a whole.

Revenue and Expenses

The revenue of member firms (Table 3-16) includes brokerage, underwriting and sub-underwriting commissions, fees for managing associated investment companies, dividend income and directors' fees. Profits derived from the firms' share-trading, arbitrage and bond dealing have been included in revenue, and losses resulting from these activities have been deducted from the figure for total revenue. In some instances, the gross interest receipts from bond holdings have been included in revenue; in other cases only a net figure has been included after the deduction of interest payments on the deposits borrowed to finance these holdings. The information in Table 5-16 reveals how predominant the Melbourne and Sydney firms have been in the stock exchange markets. The revenues of those two exchanges consistently accounted for about 85 per cent of total revenues in

Table 3-17

TOTAL EXPENSES OF MEMBER FIRMS
(Year to 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	5,575	5,912	12,130	19,324	37,521	33,463
Melbourne	8,209	9,640	18,371	22,763	31,617	27,102
Adelaide	597	706	1,402	1,504	3,022	4,706
Brisbane	981	954	2,011	2,743	4,475	3,114
Perth	260	321	941	1,264	2,872	3,160
Hobart	157	170	222	242	371	175
Total	15,779	17,703	35,077	47,840	79,878	71,720

Table 3-18

SALARIES PAID BY MEMBER FIRMS
(Excluding partners' salaries where charged as an expense)
(Year to 30 June)
Thousands of dollars

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:						
Sydney	2,183	2,166	4,545	6,019	12,734	10,945
Melbourne	3,775	4,241	8,005	10,461	14,009	12,006
Adelaide	326	362	704	926	1,509	1,125
Brisbane	428	417	917	1,243	1,720	1,173
Perth	139	172	440	664	1,305	1,765
Hobart	86	85	105	111	158	117
Total	6,937	7,443	14,716	19,424	31,435	27,191

all centres throughout the six years of varying general character and scale of the stock exchange business. Revenues obtained by Melbourne members were higher than Sydney's for the first four years, but the positions were reversed in the last two years. More often than not, Brisbane ranked ahead of the other exchanges in revenue, but on occasion Brisbane was overtaken not only by Adelaide but also by Perth. As might be expected, revenues moved very much as share market turnovers moved.

Melbourne's recorded expenses (Table 3-17) also were usually higher than Sydney's (again excepting the last two years) though Melbourne had fewer firms, doing a larger average volume of business per establishment than Sydney. Three subsequent tables, 3-18, 3-19 and 5-20, itemise elements of the total expenses, showing respectively the aggregate salaries paid by firms on each exchange, the bad debts for members of each exchange to the extent that these have been reported in the firms' accounts, and finally a comparison of rent charges borne by firms in Sydney and Melbourne over the six years.

In the accounts we received it was rare to find firms apportioning expenses against their particular functions. Hence, in the case of the firms conducting a large volume of transactions as dealers, there was no ready method of comparing the expenses incurred in running this side of the business with the expenses incurred in running the agency business. It is clear, however, that part of the expenses of the industry, and perhaps in some years a substantial part, should be attributed to the dealing activities of member firms. We observed that with some firms the major part of the revenue was obtained from dealing and underwriting, so that presumably the firms' expenses were largely accounted for by these activities rather than by agency transactions.

Salaries were consistently the largest single expense item accounting for between 38 per cent and 44 per cent of all expenses of the members of the six exchanges. There were considerable departures from this overall ratio between firms. Taking two large firms in Melbourne, for instance, during the years 1965-66 to 1969-70 salaries were usually between 52 per cent and 58 per cent of expenses. Some small firms had negligible salary expenses, and presumably the principals carried out most of the administration of their offices. It has been quite common for employees of broking firms to be paid fixed salaries plus bonuses which have fluctuated with the profits of the firms. In this way the brokers have had some immediate scope for reducing expenses in a time of declining revenue. Following the collapse of the share boom, however, there was not only a curtailing of bonuses, but a substantial decline in the number of people employed by brokers.

The remaining expenses of the average broking firms were distributed over a wide range of items, and the relative incidence differed substantially between firms. Communications charges, including computer costs, interest charges and travelling expenses were usually the largest items. In some cases where the firms were large borrowers of short-term deposits, the interest charges were up to one-third of all expenses. 'Research' expenses were also significant in several instances. One Brisbane firm increased its expenditure on this item from $7,000 in 1965-66 to $95,000 in 1969-70, when it was about 8 per cent of expenses. In the following year, however, when brokerage income fell heavily and the firm made a substantial loss, this expenditure dropped to only $200. Research was an activity which many firms cut back markedly in 1970-71 with the drop in the volume of business. A Sydney firm, for instance, had increased its expenditure on 'research and technical services' from $11,000 in 1966-67 to $285,000 in 1970, when it was about 24 per cent of expenses including bad debts and 30 per cent of expenses excluding bad debts. In 1970-71 this expenditure fell to $84,000, or to about 10 per cent of expenses. This particular firm is also an example

Table 3-19

BAD DEBTS REPORTED BY MEMBER FIRMS
(Year to 30 June)

	1966	1967	1968	1969	1970	1971
Members of stock exchange of:	$	$	$	$	$	$
Sydney	14,115	36,809	288,281	347,917	3,657,121	2,478,763
Melbourne	5,334	2,798	73,179	197,546	955,040	1,223,071
Adelaide	12,669	90	2,324	49,076	188,044	194,094
Brisbane	5,055	932	nil	7,651	252,200	378,697
Perth	nil	1,581	5,242	27,170	103,300	384,674
Hobart	nil	nil	nil	700	5,155	nil
Total	37,173	42,210	369,026	630,060	5,160,860	4,659,299

Table 3-20

RENT PAID BY SYDNEY AND MELBOURNE MEMBER FIRMS
(Years to 30 June)

	1966	1967	1968	1969	1970	1971
	$	$	$	$	$	$
Sydney members						
Gross rent	480,978	418,499	649,070	948,089	1,282,943	1,871,295
Proportion of total expenses, per cent	8.4	6.9	5.3	4.9	3.4	5.6
Change	..	-62,379	230,471	299,019	334,854	588,352
Change, per cent	..	-(12.9)	55.1	46.1	35.3	45.8

Melbourne members						
Gross rent	494,007	552,215	840,262	921,621	1,409,290	n.a.
Proportion of total expenses, per cent	5.7	5.5	4.4	3.9	4.3	n.a.
Change	..	58,208	288,047	81,359	487,669	n.a.
Change, per cent	..	11.8	52.2	9.7	53.0	n.a.

of a broker enjoying an exceptionally fast rate of growth during the six-year period of the survey. Gross commission rose from only $14,000 in 1965-66 to $1.2 million in 1969-70.

In absolute amounts of salaries paid, Melbourne maintained a clear lead over Sydney during the six years, including the last three years when Sydney had the greater turnover in the largely speculative market. In the year of contraction, 1970-71, Sydney and Melbourne made similar cutbacks in their salaries bills, but these reductions of approximately 14 per cent compared with drops in revenue of 39 per cent and 34 per cent respectively. In part this was a reflection of the necessity to maintain staffs to overcome backlogs in paper work relating to the boom period. Salaries paid in the subdued circumstances of 1970-71 were almost 85 per cent higher than those paid three years previously at a time of rising buoyancy in the share market.

Bad debt expenses, as shown in Table 3-19, have a similar element of delayed and retrospective application in fact, if not in accountancy terms. It is clear that the incidence of bad debts is highly geared to a boom in speculative share-trading, with a lag effect in the recognition of them. The trail of recorded bad debts left by the boom had exceeded $10 million by June 1971, and in the last two years particularly the rate of debt write-offs made all previous years' adjustments look minor, even if the figures are related to comparative market turnovers. Sydney's debt adjustments were especially heavy; at $6.1 million in the two years ending June 1971 they were almost three times as much as Melbourne's write-offs in the same period, and accounted for about two-thirds of the debt adjustments recorded by all exchanges. Whereas Sydney's money turnover volumes in the boom year 1969-70 were about six times as much as they had been in 1966-67, the bad debts reported were a hundred times as great, and this does not take account of additional debts emanating from the boom year which were evidently among those written off after June 1970. It is not possible to arrive at precise bad debt ratios, or loss ratios in brokers' debts, because of limitations in the available information. The Sydney figures for the last two years, however, are the best dissected into debts owed by clients and by other brokers (see Table 3-9)- Sydney in those years apparently experienced the worst debt losses, both relatively and absolutely, of any exchange in any period covered by the tables, so that these figures represent a high-water mark for such losses. The reported write-off of $2.5 million in Sydney during 1970-71 would represent 4 per cent of the gross debt outstanding at the end of that year (before write-off), or 6 per cent of debts owed by clients. In fact, the debts shown as written off in Table 3-19 are a combination of moneys owed by clients and by some failed brokers, with the former kind evidently predominating. It is doubtful whether all the bad debts suffered as the result of the failures of broking firms had been provided for in the accounts as drawn up for the final year of the table. In interpreting the tables, it is also to be remembered that not all firms record bad debt provisions in their financial statements.

The mining market boom of 1968-70 coincided with a notable rise in central-business district land prices and office rental charges, and some property developers have stated that the stock exchange boom of that period was one of the significant factors in helping to stimulate city real estate values, partly through the expansion of brokers' office floor areas, and partly from the opening of new company head offices, share registry and other attendant services in central city buildings. Table 3-20, while confirming that there was a rapid rise in brokers' expenditures on rent in those years, also indicates that rents were not a proportionately rising component of total broking expenses up to the end of 1970-71. In that year, while Sydney's aggregate rent charges, at about $1.9 million, had increased more

Table 3-21

PROFIT DISTRIBUTION AMONG MEMBER FIRMS
(Years to 30 June)
Number of firms in each category

Range of annual profits	Six exchanges			Sydney			Melbourne			Adelaide			Brisbane			Perth			Hobart		
	1966	1970	1971	1966	1970	1971	1966	1970	1971	1966	1970	1971	1966	1970	1971	1966	1970	1971	1966	1970	1971
Loss	9	12	55	4	3	24	2	5	20	1	2	4	2	1	6	..	..	1	..	1	..
Less tha	91	18	50	25	4	10	26	8	12	18	1	9	9	2	7	'6		5	7	3	7

n25,000

25,000-50,000	29	30	24	11	6	9	12	6	8	1	6	4	2	6	..	2	'4	2	I	2	1
50,000-100,000		17	36	17	5	14	8	8	8	5	2	7	2	1	3	..	1	1	1	..	3
100,000-200,000	3	41	21	3	11	9	..	18	7	..	4	1	..	3	3	..	5	1	..	..	..
200,000	5	30	6	2	17	1	3	7	4	..	3	..	..	2	..	..	1	1	..	..	..

0,000–500,000																					
500,000–1,000,000	..	13	1	..	4	..	..	7	1	..	1	..	..	..	..	..	1	..	..	..	..
1,000,000 and over	..	6	..	..	3	..	..	2	..	..	..	..	..	..	..	..	1	..	..	..	..
Tota	154	186	174	50	62	61	51	61	57	22	24	20	14	17	16	9	13	11	8	9	9

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NOTE: Profit as defined in Table 3-13

than fourfold since 1966-67, they represented proportionately a smaller element of Sydney brokers' total expenses. Rent charges had not risen relatively as much as salary and other costs in that period of four years. The last available figures for Melbourne, to June 1970, give a similar result. Up to that time, Melbourne firms in most years had paid higher aggregate amounts in rent for their office space accommodation than the Sydney payments, notwithstanding the generally higher scale of office rent charges per foot prevailing in Sydney, and despite the smaller number of separate broking establishments in Melbourne. This appears to be another indication of the bigger average operations per firm in Melbourne.

Profit Distribution among Member Firms

The pattern of the profits distribution for brokers on the six exchanges is given in Table 3-21. The definition of profit for this table is the same as that for Table 3-13, so that the disclosed salaries to partners and the interest charged on proprietors' funds have been added back to profits.

The year of the highest declared profits, 1969-70, was also the one of greatest variation in distribution of the profits. Six firms showed profits, subject to tax, in excess of $1,000,000, one of these being in Perth, three in Sydney and two in Melbourne, while no fewer than 90 firms (almost half of all in Australia) recorded profits in excess of $100,000. The highest single profit was recorded by a Melbourne firm, at $1.9 million (after adding back the payment of $165,000 in partners' salaries), compared with Sydney's highest of $ 1.5 million. But Sydney's modal, or most common, profit was higher than Melbourne's, and this was the one year when Sydney also recorded fewer losses than Melbourne (three as against five).

Table 3-22

REVENUE AND PROFITS OF THE FIVE LARGEST[1] MEMBER FIRMS OF MELBOURNE STOCK EXCHANGES 1965-66 and 1969-70

	1965-66			1969-70	
	Revenue	Profits[2]		Revenue	Profits[2]
	$m	$m		$m	$m
Firm A	2.3	.2	Firm B	7.5	1.9
Firm B	1.6	.4	Firm A	4.4	.5
Firm C	1.3	.3	Firm C	3.2	.7
	.3	.08		2.2	.8
Firm D	.3	.04	Firm D	2.0	.5
	5.8	1.02		19.3	4.4

Accounting for:

1965-66
56 per cent of total revenue Melbourne
45.8 per cent of total profit-earners[2] Melbourne

1969-70

43.8 per cent of total revenue Melbourne
34.2 per cent of total profit-earners[2] Melbourne

1 Measured by revenue. Firms which were among the top five revenue-earners in each of the two years are marked.

2 After adding back to profits the salaries of partners charged as an expense and interest charged on partners' capital.

Table 3-23

REVENUE AND PROFITS OF THE FIVE LARGEST' MEMBER FIRMS OF SYDNEY STOCK EXCHANGE 1965-66 and 1969-70

	1965-66			1969-70	
	Revenue	Profits[2]		Revenue	Profits[2]
	$m	$m		$m	$m
Firm E	1.3	.29	Firm E	5.8	.6

Firm F	.6	.15	Firm F	4.9	1.3
Firm G	.5	.15	Firm G	3.4	1.5
	.4	.24		2.4	1.4
Firm H	.3	.09	Firm H	1.9	.7
	3.1	.92		18.4	5.5

Accounting for:

1965-66

41 per cent of total revenue Sydney

44.6 per cent of total profit-earners[2] Sydney

1969-70

35.4 per cent of total revenue Sydney
37.7 per cent of total profit-earners[2] Sydney

1 Measured by revenue. Firms which were among the top five revenue-earners in each of the two years are marked.

2 After adding back to profits the salaries of partners charged as an expense and interest charged on proprietors' funds.

By the same token, Sydney experienced the heaviest reaction in 1970-71, when 24 firms on that exchange showed losses totalling $4 million, while in Melbourne 20 firms recorded losses which totalled $1.9 million. The losses incurred by three Melbourne firms which defaulted during 1970-71 and ceased to be members of the exchange have been excluded from these statistics. Among profit-making firms in this year of adjustment, Melbourne easily led Sydney, having five firms with profits each in excess of $200,000 (the highest being $777,029) while Sydney had one.

Concentration in Sydney and Melbourne

The concentration of revenue and profits among a small number of broking firms has been pronounced on most exchanges, and particularly in Melbourne. As illustration of this, Table 3-22 and 3-23 have been prepared. Again it should be noted that in the preparation of these tables any disclosed payments of salaries to partners have been added back to profits, as have any disclosed interest payments on proprietors' funds. In the year ended June 1966, the five Melbourne firms with the largest revenues accounted for 56 per cent of all Melbourne revenues, and showed combined profits representing 45.8 per cent of the total profits obtained by profit-earners in Melbourne (Table 3-22). Four of the five largest Melbourne firms in 1965-66 were also among the five largest firms of that exchange in 1969-70, though there was a reversal in the positions of the two top firms. It will be noted that the firms with the largest revenues were not necessarily the firms with the largest profits. In 1969-70, for instance, Firm C in Table 3-22 had 73 per cent of the revenue of Firm A, but earned 40 per cent more profit than Firm A. Also, one firm which was not among the five largest revenue earners in 1969-70 (its revenue was $1.9 million) had a net profit of $1.1 million, which was higher than the profits of four of the firms in Table 3-22.

Compared with the results for 1969-70, the degree of the concentration in Melbourne increased appreciably in the year of general setback, 1970-71. In that year the five firms with the largest revenues accounted for 50 per cent of the total revenue and 51 per cent of the profits of all Melbourne firms which did not incur losses. As a proportion of the net total of Melbourne profits, after deducting loss results, the predominance of the five firms was much greater.

In Sydney during 1965-66, the five most successful firms showed a combined revenue accounting for 41 per cent of all revenues recorded on that exchange, and declared profits amounting to 44.6 per cent of the total of Sydney profits (Table 5-23). Again, it will be seen that four of the firms which were among the largest revenue earners in 1965-66 were also among the five top revenue earners in 1969-70. Although these four firms retained their relative positions when ranked according to their revenues, their relative positions when ranked according to profits changed significantly between 1965-66 and 1969-70. Firm G, for instance, was third largest in terms of revenue in both 1965-66 and 1969-70. However, in terms of profit, its relative position changed from being third largest in 1965-66 to largest in 1969-70. Among the five largest Sydney firms in 1969-70, the profits as a proportion of revenue varied from 10 per cent to 58 per cent. By comparison, in Melbourne the range among the top five firms was from 11 per cent to 36 per cent.

The significance and influence of the big broking firms based in Sydney and Melbourne may also be placed in a national perspective. When combined, the five largest firms in each of those centres together accounted for 42 per cent of the revenue and 39 per cent of the profits declared by all 154 firms of the six exchanges in the year 1965-66. In 1969-70 they accounted for 32 per cent of the revenues recorded by all firms (now increased in number of 186), and for 28 per cent of the net profits declared by member firms of the six exchanges.

Share Dealing as Principals by Member Firms

We have already noted that the profits shown by broking firms from underwriting and share dealing as principals sometimes represent only part of the business being conducted by the firms' partners in these areas, the balance being carried out by the partners in their individual accounts or channelled into associated companies. Although no aggregate statistics are available on these activities of the associated companies, we have studied some instances where the profits have been very large and even well in excess of the profits recorded by the most profitable broking firms. There is no doubt that if the operations of these associated companies were consolidated with those of the broking firms, the combined profits and the combined proprietors' and shareholders' funds would be significantly greater than the totals derived from just the broking firms. Sometimes these associated companies have not had a staff of their own, but have been managed by the stockbrokers, so that a question also arises whether part of the broking industry's expenses should be apportioned to these associated companies. The accounting procedures for recording the transactions of brokers on behalf of their associates have varied between firms. In some instances commission has been charged to the associates' accounts and in other instances this has not been the practice.

The financial statements we have received likewise offer no overall indication of the partnerships' own profits from underwriting activities, but they offer some information on the results of share dealing by broking firms as principals. Table 3-24 records the aggregates for each exchange of such dealing results, from the firms which have given these results as a

Table 3-24

PROFITS AND LOSSES ON SHARE DEALINGS AS PRINCIPALS* BY MEMBER FIRMS
(Year to 30 June)

	1966	1967	1968	1969	1970	1971
	$	$	$	$	$	$
Members of stock exchange of:						
Sydney	185,092	462,484	1,399,690	(-1,435,451)	(-1,349,068)	(-3,588,001)
Melbourne	379,182	863,207	1,902,317	90,637	2,138,098	(-549,635)
Adelaide	20,673	40,637	122,463	50,258	186,781	(-56,963)
Brisbane	3,783	(-5,200)	36,685	23,846	(-26,785)	(-31,705)
Perth	(-859)	6,484	22,806	14,049	31,131	(-64,606)
Hobart	nil	nil	2,757	12,890	77,953	(-682)
Total	587,871	1,367,612	3,486,718	(-1,243,771)	1,058,110	(-4,291,592)

* In these transactions the firms were not acting as agents for clients, but were active on account of the partnership as a whole. The table covers only those firms which reported separately their losses from share dealings.

Table 3-25

DEALINGS AS PRINCIPALS* IN SHARES AND OPTIONS BY THREE MEMBER FIRMS
(Thousands of dollars)

	A Sydney firm	A Melbourne firm			A Perth firm
	End of	End of			End of

	Bought	Sold	holding	month Bought	month Sold	holding	Bought	Sold	month holding
1969									
November	1,813	1,226	1,099	2,223	2,376	26	879	814	140
December	n.a.	n.a.	1,336	3,017	4,379	477	600	453	234
1970									
January	n.a.	n.a.	920	3,585	5,897	200	2,613	1,886	259
February	3,046	2,692	1,180	6,284	7,474	265	1,041	133	127
March	800	1,246	738	873	747	158	195	3,289	58
April	2,199	2,040	1,308	1,731	1,222	5	382	264	38
May	445	507	1,318	1,182	632	4	350	242	15
June	821	1,257	817	2,701	1,987	8	1,122	829	93
July	974	1,054	734	1,409	1,050	199	362	358	70
August	783	822	706	1,123	1,066	81	610	514	117
September	650	581	769	1,913	1,247	88	484	634	50
October	1,303	1,174	981	1,894	2,285	55	404	325	134
November	1,667	810	2,289	792	803	28	51	34	126
December	633	1,470	1,434	823	631	103	82	137	119

* In these transactions the firms were not acting as agents for clients, but were acting on account of the partnership as a whole.

separate item in their financial statements. Some firms do not engage in share dealing. Of the numerous firms which do, not all report the results separately, and this is another limitation on the representative character of available figures as a guide to brokers' full share-dealing experiences.

There are various circumstances in which broking firms engage in share dealing on their own account. From time to time some firms effectively act as 'jobbers' in the market, buying unusually large quantities of shares from sellers who wish to quit their holdings in one or a few transactions rather than sell them in smaller amounts over an extended period. In this capacity a stock exchange firm may limit price fluctuations and improve the market's liquidity. Some firms carry out a dealing function by buying shares in Australia during the day for sale to London investors that night. Frequently, sales are made in London before the shares are subsequently bought in Australia. Several Australian firms carry out dealings between the two markets in co-operation with London jobbers or brokers and share the profits from such dealings with the London firms. A further type of dealing activity occurs when an Australian firm buys shares on the market or takes up new shares in an issue or placement for the purpose of selling these securities at an appropriate time for a trading profit. Trading profits are also obtained from short selling in the Australian market. We have occasion to refer to the various methods by which brokers engage in share dealings elsewhere in this Report. The point to be made here is that in the records we received relatively few firms separated in their profit-and-loss accounts the profits or losses obtained from the various kinds of dealing. In many instances the results from all these dealings were shown under the heading of 'share-trading'.

A notable feature of this share dealing or share-trading is that some firms which have engaged in these activities have had a rapid turnover of their holdings. It was not possible to collect statistics for the whole industry on these dealings, but a special survey was carried out of a group of seven firms for the period November 1969 to December 1970. The results for three firms based in Sydney, Melbourne and Perth are shown in Table 5-25. At the time, the Sydney firm was one of the largest in Australia, the Melbourne firm a medium-sized business, and the Perth firm one of the largest on the Perth Exchange. In the case of the Perth firms, the purchases and sales over the fourteen-month period totalled about $19.1 million, giving an average of $1.56 million a month. By comparison, the end-of-month holdings averaged about $115,000 over the same period. These statistics in Table 5-25 reveal how some brokers have engaged in extremely large principal dealings in shares and options. It is also clear that such dealings were at particularly high levels during the months of the Poseidon boom. For instance, during the four months November 1969 to February 1970, a Melbourne firm's principal dealings totalled about $35.2 million, or a monthly average of $8.8 million. Again, it will be observed how the end-of-month holdings of shares for this firm over that period ranged between the relatively small amounts of $26,000 and $477,000.

One of the most interesting findings of this analysis of brokers' records is that Sydney brokers as a group recorded a heavy net loss on share dealing over the six years (Table 3-24). While the first three years are shown as yielding them net profits amounting to $2 million, the losses reported for the next three years were $6.4 million, leaving an adverse overall result of $4.3 million over the full period. In the latter three years, the number of Sydney firms reporting share-dealing losses were nineteen, sixteen and twenty-three successively, and in 1970-71, when the aggregated share-dealing result for Sydney was a loss of

$3.59 million, one firm alone showed a trading loss in excess of two million dollars.

Sydney's share-dealing results contrast with those of Melbourne. The numbers of Melbourne firms reporting share-dealing losses in the last three years were similar to those in Sydney (being sixteen, thirteen and twenty-nine successively), but their results were more than offset by the profits earned on trading by other Melbourne firms, except in 1970-71, when the net aggregate was a loss of about $550,000. Melbourne's overall results for the six years was a net profit of $4.8 million from share dealing.

Sydney's loss record on brokers' share dealing in the three years ended June 1971 is unique for its consistency as well as scale, and even includes a severe net loss of $1.3 million in the year of the 'Poseidon boom', 1969-70. That figure in particular must be treated with care because of the existence of associated share-trading companies effectively owned by the partners of broking firms and their families. The Committee has noted several instances in the course of its inquiries of brokers directing the burden of loss-taking from such companies into the partnerships, so as to minimise their liability to taxation. It was also possible in that period of frequent mining and oil company flotations to claim tax deductions on new shares under Section 77 of the Taxation Act, and on balance to gain from a re-sale at prices nominally below the subscription price, with the recorded losses on trading more than offset by tax advantages. The extent of these elements in the Sydney figures cannot be calculated.

In the market downturn of 1970-71, all six exchanges showed aggregate net losses on share dealing, and these amounted to $4.3 million. It should be apparent that these losses had little to do with sharebroking as such, and were extraneous to the results of the agency functions of broking firms. When adjustment of the figure in Table 3-13 is made for this, the profits derived essentially from broking on all exchanges in 1970-71 (but also including underwriting income) was evidently of the order of $4.7 million. Such a result also has to be considered in the light of the exceptional and temporary overhang of office expenses and bad-debt write-offs that affected brokers' profits in the aftermath of the boom. The debt write-offs alone were $4.6 million in that year. In addition, the overall result shown in Table 5-15 was significantly affected by the bond-dealing losses incurred by certain member firms on their own account. We have referred to the combined loss of over $2 million recorded by three firms from this activity. It may be concluded that the intrinsic profitability of broking as such was much greater in 1970-71 than the figures in Table 5-15 suggest.

Introduction of the Order Fee, 1971

Early in the following year, 1971-72, Australian stock exchanges increased their charges for negotiating share transactions by the introduction of an 'order fee' of $5, applying to all orders from clients. The order fee replaced the minimum brokerage charge of $2 for orders of between $10 and $100 and $1 for orders of less than $10. This was the first substantial change in brokerage rates on share transactions since 1965 when the flat rate of 2 per cent was introduced on the first $10,000 of consideration with the rate reducing to 1.5 per cent on the next $40,000 and to 1 per cent on the amount by which the consideration exceeded $50,000. These fees were fixed by the stock exchanges acting collectively and they have continued to apply up to the time of writing. They are not minimum rates which can be exceeded by individual firms, but are the rates which members of the stock exchanges must charge. The fees have been charged at both the buying and selling ends, even when the same broker has been acting for both parties.

At the time the order fee was proposed, most of the stock exchanges were operating under new State government legislation which required them to obtain approval from the State authorities for the change in their rules concerning the new fee. Thus an opportunity was presented to these authorities to inquire in detail into the profitability of brokers and their reasons for introducing the new charge. As this Committee has been interested in aspects of these questions, we inquired of the President of the Australian Associated Stock Exchanges (AASE), Sir Cecil Looker, about the information prepared by the AASE on the reasons for this new charge. In reply, Sir Cecil Looker forwarded to the Committee a copy of the AASE submission which had been sent to the Attorney-General for Victoria, The Honourable G.0. Reid, M.L.A., and this is reproduced as Committee Document 5-1.

According to the submission, the new transaction fee was to be intended to meet increased costs and in particular to reduce or make less expensive the fulfilling of small orders on behalf of clients. The relevant section in regard to costs was as follows:

The Exchanges have noted the substantial increases in costs borne by Members in recent years. By way of illustration, the following schedule reflects percentage increases in costs which have been experienced over the six year period ended March, 1971

<u>Salaries</u>	%
Senior Scrip Clerk	178.6
Operator	223
Accounting Machinist	175
Accounts Reconciliation Clerk	182.9
<u>Communications</u>	
Telephone calls	50
Rent	17.25
Cables	60
Postage	50

	%
Printing & Stationery	174.1
Rent	225.5

While there can be no doubt that the costs of the services required by the stock exchange firms had risen greatly during the years 1965 to 1971, it was also true that the revenues of stock exchange firms had risen dramatically. The submission did not, however, refer to these higher revenues; nor did it refer to the levels of profitability within the industry or to changes in the trend of profitability. The quotation of percentage increases in costs of certain items without referring to the increased revenues and the levels of profitability (appropriately adjusted to allow for the losses derived from the brokers' own dealings) was to give only that part of the case most favourable to the brokers' submission for an increase in charges. By itself, this information was misleading as to the financial state of the industry.

The submission went on to say:

Recent analyses by Member Firms suggest that the cost of producing a contract note ranges from $8 to $12. In many cases more than one contract note is issued to complete the order.

The introduction of an order fee of $5 will not cover costs of transactions involving low price securities but will bring some relief to Members who are asked by their clients to effect such transactions.

The preponderance of business today is in the price bracket below $1, and this is the area where paper work and attendant costs are also the greatest.

Again, there is no doubt that many brokers had been called upon during the boom to execute small orders for clients. However, the submission contained no information about how the 'cost of producing a contract note' had been calculated. There was neither a statistical analysis nor a description of the procedure used. As the submission made no reference to the overhead costs incurred by stock exchange firms in conducting their own dealings, it was not possible to tell whether these had or had not been included as part of 'the cost of producing a contract note'. No mention was made of the differing experiences of different sizes of firms in their unit costs of conducting agency business. Stock exchange firms provide different types of services for clients, but it was not stated which of these services had been allowed for in 'the cost of producing a contract note'. For example, some firms provide expensive research services for clients and expect to cover the costs of the services from their commission earnings. On the other hand, some firms do not have a research department. It may also be noted that there was no reference in the AASE submission to the scope for reducing the unit costs of processing orders within the industry by introducing new techniques of scrip handling and market organisation.

Although the stock exchanges appeared to be primarily concerned with the costs of transacting small orders, and it was stated that the order fee would not cover the costs of completing some such orders, the same fee was to be paid on all orders. In our view, this method of fixing charges should be questioned.

A notable feature of stockbroking is that the marginal costs of negotiating a transaction drop sharply with the size of the transaction, so that the marginal cost of completing, say, a $10,000 transaction is not ten times that of completing a $1,000 order. In a capital market where stock exchange firms were engaged in effective competition either among themselves or with other markets for investors' business, one would expect brokers' charges to reflect these declining marginal costs. In fact, the commission charges on share transactions of the stock exchanges in 1971 (still in force) made some allowance for this declining incremental cost. However, in the case of the order fee, the stock exchanges proposed to impose the same charge on an institutional order of, say, $10,000 as on an individual order of $100. The stock exchanges were therefore proposing to increase their profit margins over marginal costs on large transactions relative to their profit margins on smaller transactions. The Committee is not aware of financial institutions in Australia protesting about this action, but it was, nevertheless, a sign of monopolistic discrimination by the stock exchanges. In the case of the order fee, institutions were not to be permitted to realise those economies arising from their generating a large volume of business. Any stock exchange member who elected to offer a specialised agency service in transacting institutional business at a reduced order fee which reflected the incremental costs of conducting the business would be breaking the rules of his exchange. On the face of it, there was reason for believing that the exchanges were proposing an order fee which, in respect of some business, would be higher than it would turn out to be under effective competition.

In summary, the submission was deficient in much essential information and was generally inadequate as the basis for an increase in the costs imposed by the stock exchanges on all members of the investing public. We were informed, however, that the president of the AASE was not asked for any further information, and Sir Cecil Looker also said that he was not aware of the Victorian Government's taking any steps to collect additional information. There was criticism of the new charge in the Press, but the stock exchanges did not reply by providing the public wits statistical data to support their case for an order fee. It is also doubtful if the committees of the exchanges were in a position to supply such information. To the best of our knowledge, neither the stock exchanges which decided to impose the charge nor the State authorities to whom the proposal was referred had assembled aggregate figures of brokers' profit experience, such as has been presented in this chapter, before arriving at their decisions.

The important question which should have been asked in 1971 when the stock exchanges raised the subject of their commission charges was whether the public interest would have been better served by replacing the structure of fixed commission rates with competitively determined rates. Such an inquiry would have raised the question of whether the existing rate structure was distorted in comparison with what would be optimal from the viewpoint of the efficient and equitable operation of the share market. One of the tasks of the new national regulatory body which we recommend should be the periodic examination of the level and structure of commission rates in the industry. The ~ costs paid by investors for buying and selling shares in the public share market should be of continuing interest to a government regulatory authority; it should not simply acquiesce in the charges determined by the collective action of the six main stock exchanges o

Concluding Comments

The six-year period covered in our survey of the profitability of the broking industry included a speculative boom of unprecedented proportions, which brought very high profits and also severe losses for some broking firms. In an industry subject to continuous change, it would be impossible to say how representative or unrepresentative the average results of the six-year period (or perhaps of any similar period) were, but there is evidence that since the end of the period the scale of share market activity has remained high by any criteria existing before the highest peak of that most recent speculative boom. The Committee has noted figures produced by the Melbourne and Sydney exchanges relating to the level of market trading volumes in the two financial years since those covered by the series of tables in this chapter. The money value of the combined share turnovers on these two exchanges in 1971-72 was approximately $1,548 million (Melbourne $859 million, Sydney $68 million). In the next year, 1972-73, the combined turnover value was higher at $1,761 million (Melbourne $924 million, Sydney $837 million). Turnovers of mining and oil stocks represented less than one-third of the 1971-72 turnovers and about one-quarter of the 1972-73 figure. Each of those years' combined turnovers for Sydney and Melbourne is several times higher than those of any of the first two years which were covered in our tables of brokers' accounts, and the second of them, for 1972-73, was fully equal to the corresponding turnover for the first of the boom years, 1967-68, which was highly profitable for brokers. While the nature of the content of share business being done on the exchanges has changed, the volume has been very high by any except the most extreme standards reached in the speculative boom of the late 1960s.

In the meantime, however, the number of individual share transactions on the exchanges has fallen sharply, according to statistics of transactions published by the Stock Exchange of Melbourne. In 1972-73, the number of transactions on that exchange (including preference shares) was only 493.5 million. In the previous five years, beginning in 1967-68, the corresponding numbers of transactions had been successively: 932.1 million, 93 1.1 million, 1,276.1 million, 895.7 million and (in 1971-72) 570.9 million. The introduction of the order fee early in 1971-72, and the general switch from trading in mineral stocks to more highly priced industrials, have evidently contributed to this noteworthy development. In 1972-75, with the money value of Melbourne share turnovers higher than it was in 1967-68, the number of transactions in shares was only 53 per cent as many. In accordance with the reasons offered for the introduction of the order fee, this development would appear to have been a factor helping to reduce the expense rate, or to check rising costs, in broking offices in relation to volume of business performed and brokerage revenues received.

Although there are six stock exchanges based in the State capitals, in practice these exchanges are closely integrated with a high proportion of the business initiated in any one State being executed in another State. A representative of the Melbourne Stock Exchange provided the Committee with statistics collected by the six exchanges showing this distribution of business over a period of about one week in 1970. In the case of Melbourne firms, the percentage of orders executed locally was 77.1 and the percentage executed inter-state was 22.9. With Sydney firms, the respective percentages were 83.3 and 16.7; with Adelaide firms, 45.5 and 56.5; with Brisbane firms, 46.1 and 53.9; and with Perth firms 51.5 and 48.5 (Ev. 1507). In other words, on the basis of this sample, about half of the share transactions originating with Adelaide, Brisbane and Perth firms were executed in other States. It appears that most of this inter-state business has been directed to Sydney and Melbourne. There is some doubt about the extent to which these inter-state transactions have been reported to more than one stock exchange, so that there could be a substantial amount of double-counting in the turnover statistics of the six exchanges when these are added together. This is a question which should be clarified so that the public is provided with accurate data on sales of listed securities. Nevertheless, it is clear that there is a national market in Australian share securities with the Sydney and Melbourne firms accounting for by far the major proportion of turnover.

A further matter which will require the attention of a national regulatory authority is the present lack of uniformity in the preparation and presentation of the financial accounts of members of the different stock exchanges. Judging from our own experience, regulators cannot adequately carry out their responsibilities unless they regularly collect and have available comparable information from all firms in the industry. In particular, an accurate assessment of the relative profitability of the agency business compared with the firms' dealing activities depends on having the accounts prepared in a way which shows the break-up of the two sides of a firm's business. In our opinion, too, it is an anomalous situation whereby stock exchange firms can borrow very large sums from the money markets and accept substantial deposits from the public without ever having to publish or file for inspection a balance sheet statement, or even conform to specific balance sheet ratios laid down by a regulatory authority.

The fortunes of stock exchange firms from year to year are extremely variable. This is partly explained by the restrictions on entry into the stock exchanges, but it is also in part a reflection of the flexibility that the exchanges have shown in absorbing rapid changes in their level of activity. The fact that more than one-third of the revenue and profits earned in the industry is attributable to only ten Sydney and Melbourne firms, each having relatively large resources, may be another element in the exchanges' capacity to meet fluctuations. The industry is nevertheless conducted on a small base of proprietors' equity in relation to the scale of business, and has been heavily dependent on the banks for financing its growth. The obverse side of the flexibility of the system is that brokers' almost total dependence on external finance in periods of rapid expansion can leave them extremely vulnerable to the effects of misjudgments, to weaknesses in management or debt control and to the results of their own share speculative activities. It is when share prices turn sharply downwards that the industry is usually forced to face up to these problems, and the corrective measures required can be especially difficult if, as tends to happen, the turnaround in share prices is accompanied by a marked tightening of credit and a rise in interest rates. The clients ultimately suffer for the firms' mistakes, and the large number of failures of firms in the aftermath of the 1970 boom has brought a series of extremely protracted proceedings for the settlement of their affairs, with serious deficiencies in the client trust accounts in some cases, and little clarification of the relief that may be expected for these clients from the fidelity funds of the exchanges. The financial structuring of the broking industry, in relatively unsupervised conditions, has contributed to these consequences.

CHAPTER 4
THE CONFLICTS OF JOHN T. MARTIN & CO.

Introduction: The Sydney Business of a Melbourne Broker

The sharebroking firm of John T. Martin & Co. was in operation for only thirteen months, but it came into existence as so much of a going concern, having substantial connections and a wide range of active interests, that it was easily the biggest~ as well as being the shortest-lived, of the several broking businesses which went into default during the currency of the Committee's investigations. The scale of its financial deficiency and other losses it brought upon the investment community through its company involvements was correspondingly large and grievous. At the time of preparing this Report the firm's own deficiency exceeds $1,300,000, and the visible losses which the firm can be held to have imposed on two public companies of its promotion are probably more than $1,600,000, so that total losses approaching $3 million, incurred in a short time, will have to be borne by others in the community.

The full dimensions of the losses, and the range of circumstances which produced them were not known to this Committee when it decided, soon after John T. Martin & Co. defaulted on 6 April 1971, to extend its inquiry into the firm's affairs. At that stage, the Committee rather saw an opportunity to obtain concrete information in some detail on the working of the sharebroking industry and the regulatory framework, while imposing a minimum of inconvenience on those who were still actively engaged in the industry. It was conscious of the fact that there had not been a study at length of the actual workings of a stockbroking firm, even a defunct one.

An attempt is made in this chapter to explain those of the Committee's findings, many of an unexpected character, which appear to have some general significance. The most important of them relate to the generation of what are commonly called 'conflicting interests' by a resourceful broking firm, though the conflicts may in fact be purposefully and systematically resolved to the advantage of one party. In this instance the broker simultaneously filled the roles of commission agent, share trader, client adviser, company promoter and underwriter, supplier of geological advisory services, company director and remote controller of companies of which he was not a director. Another general consideration arising from ~ examination of the history of John T. Martin & Co. is the degree of inherent advantage available, under systems of informal or 'club-like' supervision, to those who may resourcefully apply themselves to a policy of concealment and avoidance of the informal code of behaviour while maintaining an attitude of confident assertion that they are adhering to the code.

Investigation of this firm's affairs brought other matters to notice. One was the degree of risk in the scope that may be given to employees of a broking firm to trade speculatively in shares with special credit privileges, to the point of compromising the financial solvency of the firm and the security of funds lodged by its clients. It will also be observed how employees may jeopardise a broking firm's solvency by their indulgence of recklessly speculative clients.

John To Martin & Co. was a firm in which the tail might be said to have wagged the dog, in that the scale of its brokerage activities in the Sydney branch office was much bigger than at the Melbourne headquarters. This fact helped to give the major part of the firm's operations additional immunity from stock exchange and State government surveillance under the present system in Australia of fragmented responsibilities for control. The

Sydney Stock Exchange did not have administrative jurisdiction over the firm's operations in that city, while the distant Melbourne Stock Exchange, which possessed the technical authority, had no knowledge of these Sydney affairs and did not seek to obtain it. Within the firm itself, the distance of the main centre of broking activity from the administrative headquarters exacerbated weaknesses in staff control. Partly, but only partly, for these reasons, grave deficiencies developed in the firm's statutory trust account for clients who were in credit with it by reason of payments they had made for undelivered share scrip, and the depletion of the trust account went undetected by any authorities, and even by the auditors. Among the other issues raised by the investigation of John T. Martin & Co., it will be necessary to observe in this chapter the scope which exists, in conditions of inadequate supervision, for improper exploitation of the upward effect on prices of offers to the market for substantial parcels of shares.

Mr John Taylor Martin had been working in the share broking industry for thirteen years, including a period of experience in London, when he established the firm bearing his name, and opened for business simultaneously in Melbourne and Sydney on 5 March 1970. For the previous four years, he had been a member of the Stock Exchange of Melbourne, holding the position of Sydney resident partner of A.C. Goode & Co., a firm which had its headquarters in Melbourne. In that capacity he had worked continuously in Sydney before he resigned from A.C. Goode & Co. at the end of 1969 to establish his own business. Into that business he attracted a number of executives who combined considerable experience in sharebroking and related financial activities with a range of tertiary educational qualifications. One of these was Mr Sydney Harold Massey, who had thirteen years' previous experience in the broking industry. Mr Massey was appointed as Sydney office manager, and in October 1970 also became the resident Sydney partner of John T. Martin & Co. In that month, Mr Massey, who had never lived in Melbourne, became a member of the Stock Exchange of Melbourne. Mr Martin himself, having now changed his residence to Melbourne, usually spent part of each working week in Sydney.

John To Martin & Co. had been conceived and born in a period of intense speculative share trading, which was especially marked in Sydney. In explanation of his reasons for opening simultaneously in both capital cities (and subsequently opening a Canberra office for a short period), Mr Martin told the Committee that the business of his firm 'was largely institutional dealing - that is to say, to deal for the established life companies and large buyers and dealers in shares and also in such issues as Commonwealth bonds, semi-governmental securities, debentures, generally fixed-interest securities' (Ev. 1585). When dealing in large parcels of this nature, it was helpful to have the widest available market, both to obtain the parcels and to obtain buyers of those parcels. Hence he considered it necessary to have an office in Sydney as well as one in Melbourne. Mr Martin said that his own business contacts at this time were stronger in Sydney than in Melbourne, as he had not operated as a broker in Melbourne for about eight years. He said that 'as a member of the Stock Exchange of Melbourne, I suppose one's head office should be in Melbourne, although it is not absolutely necessary. I think the practicalities of the matter mean that it must be, but also the practicalities of dealing with institutions, as I have described, means that you must have a Melbourne-Sydney axis if you are going to operate effectively' (Ev. 1585).

The Committee's inquiries confirm that John T. Martin & Coo opened for business with a substantial institutional clientele, especially in Sydney. The firm began with excellent auspices. At the same time, it is clear that Sydney had another significance for the firm's establishment. Mr Martin had been preparing to involve his firm in promoting speculative share account business from the time it came into existence, and this kind of business was to have a predominantly Sydney orientation. For example, Mr Martin played a leading role in the formation and early conduct of a company, Australian Continental Resources Ltd, which was floated in April 1970, a few weeks after John T. Martin & Co. formally commenced business. The history of this association will be discussed in more detail later, but it may be mentioned that Australian Continental Resources, of which Mr Martin was an active and influential director at this stage, put a total amount of $5o7 million of share-trading business (buying and selling) through John T. Martin & Co. in its first eight months, and was to suffer heavy losses in consequence of this trading. Again, in October 1970, this broking firm promoted, underwrote and largely directed another public company, Glomex Mines N.L., which also proceeded immediately to deal in speculative stocks, largely through and on the advice of John T. Martin & Coo This company, like the first one, operated from Sydney, having been put to a large extent under the effective management of two Sydney employees of John To Martin & Co.

These were some of the factors making both for a big speculative element in the agency business and for Sydney's dominant contribution to the total agency business. It has been ascertained that in the firm's thirteen months' existence, the agency turnover of the Sydney branch was $25,595,000, while that of the Melbourne head office was less than one-third as much, $7,947,000. (The Canberra branch's turnover was only $181,000. These relative gross turnovers meant that revenues from brokerage commissions originating in Sydney were about twice as high as those derived in Melbourne, after allowance is made for the necessity to 'split' the commission on the greater part of the Sydney business, because the firm, not being a member of that exchange, could not trade directly on it. The Committee finds that about three-quarters of the business generated in the Sydney office was directed through members of the Sydney Stock Exchange who acted as agents for John To Martin & Co. The rates of sub-commission paid to the Sydney brokers was usually two-thirds of one per cent on orders for amounts up to $10,000, and one-half of one percent on orders above $10,000. Since the commission rates paid by the clients of John T. Martin & Co. would have been two per cent and mostly 1.5 per cent respectively, this meant that two-thirds of the total commissions were retained by John T. Martin & Co. and one-third went to the Sydney agents, while approximately one-quarter of the Sydney-generated business was not split but directed largely through the firm's Melbourne office for dealings on the Melbourne Exchange.

It could be said, on the above figures, that John T. Martin & Co. was more a Sydney broking business than a Melbourne one, although, as we have noted, the Sydney end of its business was relatively free from external surveillance. Mr Martin, in evidence, recalled that he had not sought prior approval from the Sydney Exchange, nor had he been required to have communications with that exchange or any State authorities, in order to be able to open a branch in Sydney. For that right, he applied to the Melbourne Exchange, and his account of the procedure involved in seeking and gaining approval is as follows: 'To the best of my recollection it was simply verbal. I advised the Stock Exchange of my intention to open offices in both Sydney and Melbourne on the same date, and later on also to open up in Canberra' (Ev. 1386). In making this notification, 'there was no specific information relating to Sydney branch' (Ev. 1387). He was not aware of the committee or the executive of the Melbourne Stock Exchange ever making any visit to the Sydney branch of his firm, nor had there been any visit of inspection or inquiry into its operations from the Registrar of Companies in New South Wales, apart from one or two questions relating to dealings in certain particular shares, which had been directed to other broking firms at the time.

Since the behaviour of employees in Sydney and Melbourne contributed substantially, but by no means exclusively, to the early downfall of John T. Martin & Co., a summary account of the circumstances leading to that collapse can begin with an assessment of the effects of two kinds of employee activity: first, their direct share trading, and secondly their indulgence of dangerous speculative clients.

Share-Trading Practices Leading to the Collapse

Employees' Trading in Shares

The system of privileged share trading which was extended to employees of John T. Martin & Co. was not peculiar to the staff of that firm but, according to several witnesses, was the practice in many other firms also. The essence of the privilege was that employees were not required to pay immediately upon receipt of the contract note for shares bought on their behalf, as ordinary clients of a broking firm must do. Instead, they were allowed to defer payment until the actual delivery of the share scrip (as some big institutional clients are permitted to do). This was an encouragement to speculative trading by members of the staff, and in the market at the time speculation had to be the expected result. Neither the stock exchanges nor any other authorities appear to have any knowledge of the full extent of this practice.

In the case of John T. Martin & Co., the Committee found that nearly all of the payments made by employees in settlement of debt to their employer came from the proceeds of resales of shares bought on credit, and not from the introduction of new money. The employees were, generally speaking, not persons of much financial substance; by this practice they were being encouraged to trade beyond their means. Their reliance on the credit terms made this a quick turnover business, at least to the extent that the subsequent price movements of the purchased shares would permit quick release without loss. Some of the most active employee-traders held positions as investment advisers to clients of the firm. The prescribed office procedure was that an employee who wished to trade in shares should have the order initialled by a senior authorised person, of whom there were two in Melbourne and three in Sydney. Each of the authorising persons could trade on his personal account on his own authority, and some did so very actively. There was no checking procedure to ensure that operators were not effecting orders on behalf of themselves or other staff members without the prescribed initialling. Mr Martin said in evidence that he had not made subsequent inquiries to find out what proportion of actual employee trading had 'slipped through the system', and he had no reason to believe it had been considerable. No separate record was kept of the extent of the running total of employees' outstanding transactions and debts to the firm.

When Mr S.H. Massey, as the Sydney partner, was asked by the Committee whether he thought it desirable that employees should trade in the shares of companies with which the firm had associations as underwriter or in other capacities, he said:

I have never seriously thought about it. The view that I take on this is that it is unrealistic to imagine that senior men in a field as exciting as broking can withhold from the desire to buy and sell shares on their own behalf. I think if one put a black ban and said you cannot trade or buy any shares this would lead to a much greater evil, and that is [the reason for] a rule that appears in the Sydney and Melbourne Exchanges which says that a member of the firm can only deal through the firm with which he is employed. This is for a very good reason. It is to prevent him from taking advantage of information which he might be given in his duties in the firm and taking the business to another broker. This would prejudice the client. For instance, if he places an order to buy half a million shares and then goes to another broker and places an order of 10,000 for himself, clearly the client would be prejudiced ...

(in camera)

That there are, however, a number of weaknesses in this argument is shogun by an examination of the affairs of John 'T. Martin & Co. In the first place, employees of this firm resorted to a great variety of pseudonyms as well as to the use of proprietary companies to conceal their interests as share traders. 'This could be done most effectively in one's own office of employment. The purpose of the disguises was two fold, according to the firm's office manager, Mr John Montgomery Maddox, in evidence. One reason was to avoid the supervisory system which required that staff purchases be approved by a senior member of the office. The alternative, and probably more common, object was tax evasion. In fact, it seems that some employees, perceiving that they had a choice between, on the one hand, obtaining privileged credit on investments in their own names, or other names accepted by the firm, and on the other hand evading tax by total concealment, may have adopted a policy of getting a bit of both worlds by simultaneously trading under recognised names and under various disguises.

Another complication which came to the Committee's attention was the practice among some employees of 'line-switching' of share scrip as between transactions made on their own behalf and those for clients. This was only possible for someone inside a broking firm to do. The practice of line-switching is described elsewhere in this Report (see Chapter 5). The effect in this case would be to arrange the timing of an employee's liability to pay for scrip to his own maximum advantage, which could be to the disadvantage of the client whose time was rearranged.

When the Committee inquired of another employee of this firm, Mr Nell Charles Handley, who worked in the capacity of an investment adviser, as to what scale of income the broking employees obtained from their own share trading, Mr Handley said the answer would be 'a minus quantity'. He reiterated this opinion under examination as follows:

Senator Wheeldon: A minus quantity? They are all losing?

Mr Handley: That is about right.

Senator Wheeldon: These are the advisers?

Mr Handley: That is pretty right.

Senator Wheeldon: That is worth remembering, I suppose. You are quite serious about that?

Mr Handley: I am very serious ... my experience has shown that advisers are a bit too close to the market for a start to be able to stand back from it and see it clearly, and my observations have also shown me that they invariably do not buy stocks that they recommend to their clients. They take a bigger risk for themselves than for their clients.

(Ev. 1806)

Mr Handley's pessimistic view of the results of experts' trading on their own account receives support from the experience of employees of John T. Martin & Co., and also from the trading experience of that firm itself on 'house account', according to figures which the Committee has been able to obtain. It has been ascertained, for example, that in the last seven months of the firm's life, when its house-trading activities developed substantial volume, its net losses on this business exceeded $300,000. The exact figure for employee losses and for the consequent bad debts they left in the firm's books is harder to determine because of various associations which some members of the staff had with proprietary companies and investment syndicates. Excluding such associations altogether, the final total of employee bad debts in various personal names and pseudonyms is in excess of $300,000 after all realisations and reconciliations have been made. The gross amount owing by employees and associated proprietary companies at the date of the firm's default in April 1971 had appeared to be about $575,000 (Ev. 1401), a figure which must now be regarded as conservative.

Although Mr Martin and Mr Massey at first agrued in evidence that the amount owing at that late date in April 1971 was untypical and that there had been an instantaneous or dramatic build-up of employee debts through 'defalcations' in the last days of the firm's activity, the Committee's inquiries into the balances owing over a period of several months before the firm's collapse do not bear out these claims. One of the partners, Mr Massey, subsequently acknowledged the justification of the Committee's conclusions (in camera). The Committee found, for instance, that on 30 November 1970, the amount outstanding in respect of staff, their companies and syndicates had been $317,000 - a large amount of credit for a firm of this size to extend to persons of generally modest credit rating and having the fatal loss-prone tendencies in their speculation which have been described by one of them. Nor was the figure on 30 November an isolated peak; for example, the Committee has found that the amounts outstanding in mid-December 1970, in respect of one Melbourne employee alone and his associated interests exceeded $131,000.

In extenuation of the firm's record, it was claimed by witnesses that employee trading on favoured credit terms was prevalent in the broking industry, and that in the case of John T. Martin & Co. the number who did so trade was a minority of about ten per cent of the staff. On the first point, the Committee has direct evidence which shows that the practice has not been confined to this firm, though it does not have quantifiable data on the general extent of employee trading under the privilege previously explained. But if employee trading is a common practice (see Chapter 6, and also Ev. 1300-9) this does not justify such standards as prevailed in the firm of John T. Martin & Co. On the second point, it is true that no more than about twelve members of the staff of John To Martin & Coo appear to have gone appreciably into debt in respect of their own trading. The firm's total complement of employees, counting the part-time and night-shift helpers, was about one hundred at the peak period. But a concentration of debts amounting to more than $500,000 among a comparatively few employees does not lessen, and may heighten, the dangers of the practice. It introduces more than one kind of uncertainty into the behaviour of broking firms. Such debts not only contribute to the risks of a firm's insolvency in a market downturn. In addition, although Mr Handley told Senator Wheeldon that investment advisers usually buy different stocks for themselves from those which they recommend to clients, there obviously cannot be any assurance that this will always be the case. A broking employee who finds himself holding stocks which he must shortly resell in order to liquidate a debt (possibly concealed from his employer by the use of pseudonyms) may be tempted to advise clients to bid up the price of the stocks in the hope that this will permit him to sell at an appropriate price. Questions of conflicting interest do on occasion press at least as heavily on an employee of a broking firm as on its principals, and employees are not formally obliged to declare themselves parties to market transactions, or to issue a special form of contract note for their trading activities, as broker principals are supposed to do.

Employees' Indulgence of Short-Selling Clients

For a firm which had been in existence for only thirteen months, though admittedly months of speculative boom in the share market, John T. Martin incurred its full share of bad debts. On the most recent estimate available to the Committee, the bad debts are likely to exceed $700,000. Some of the debts relate to the buying in of shares at high prices on behalf of clients whom the firm found to have been short-selling (placing selling orders through John To Martin & Co. for shares they did not possess at the time); but since the selling orders were given only verbally to employees of the firm, and the clients in question subsequently deny having placed selling orders, the firm was left in an extremely vulnerable position. Mr Massey agreed with a suggestion that 'the broker is at the mercy of his employees so far as this risk is concerned' (in camera), and he claimed specifically that if one particular client had not given orders for the sale on 18 and 19 March 1971 of contributing shares in Leopold Minerals N.L. which he did not hold, then John T. Martin & Co. 'would still be in business'. The Committee will shortly offer an assessment of this claim, but there is no doubt that the firm's involvement, in the widest sense, in Leopold shares was the proximate cause of its collapse. The involvement was a response to rumours and an official report of rich nickel discovery which proved false, and which created a false market for a brief period.

The sequence of events by which the frenzy of speculation in Leopold Minerals brought down John To Martin & Co. begins with the transactions of the client whom Mr Massey blames for the downfall. This client was a Sydney resident who dealt mainly with one employee of the firm's Sydney office. One of these two persons was absent overseas during the Committee's investigations. For present purposes, they will be described as 'The Client' and 'The Employee' respectively.

The Client and The Employee had known each other for a long time before either of them had any connection with John T. Martin & Co. The records show that The Client began trading with the firm on 10 July 1970, and later he also placed orders in the name of his life. In the nine months from July until the collapse, John T. Martin & Co. issued 169 contracts for purchases by The Client himself, and 145 contract notes for sales. These transactions involved 51 mining stocks. At no time was any consideration in the form of cash or shares, received from The Client as security against his overdrawn account. Excluding the final transactions in Leopold Minerals, the trading operations had involved The Client in net losses of $44,252, while transactions on behalf of his wife had produced a further net loss of $5,474. The Client had thus established himself as an increasingly heavy debtor to the firm as his losses mounted and, on the evidence available, the continuing process of indebtedness was still being tolerated, and indeed remained unquestioned.

That the Melbourne head office also was aware of The Client's short-selling habits before the Leopold transaction is shown by a memorandum and attachments addressed by the officer in charge of settlements in Melbourne, Mr Robert Burnett Gray, to Mr Massey in the Sydney office on 3 March 1971. The memorandum read as follows:

I enclose a list of clients with short positions. Could you please draw the attention of all your advisers to the following extracts of the Memorandum and Regulations of the Stock Exchange of Melbourne, under whose auspices this firm does business.

ARTICLE 88

'A member shall not sell or offer to sell to any person securities not owned by himself or a client except as provided for in the regulations.'

With the auditors shortly coming on our doorstep, we will be called upon to explain why a number of Sydney clients appear to be habitual shorters.

So, can you please ensure that this practice ceases immediately.

The list of 'short positions' accompanying this memorandum quoted the names of several persons, including those of The Client and his wife, who were shown as being short in shares of Southland Mining N.L. and Tasminex N.L. The Melbourne office was classifying them among the 'habitual shorters'. In spite of this warning in the Melbourne memorandum of 3 March, short selling continued in the Sydney office until the climax of a fortnight later.

The Committee was not given any clear explanation as to why short-selling had persisted against the rule of the Melbourne Stock Exchange up to the date of the memorandum, let alone why it continued thereafter. We note that the Sydney branch of Martin - in terms of business, the firm's main office - was operating in a climate where short-selling was permitted by the local exchange, and was in direct competition with members of that exchange who enjoyed that freedom. The Melbourne office's knowledge of the existence of 'habitual shorters' in Sydney appears to have promoted belated warnings only in a context of an imminent possibility of detection. An even later warning from Melbourne, in a memo from Mr Gray to Mr Massey dated 2 April 1971, said: 'now that everything is under intense scrutiny any further shorting would be frowned upon and would most certainly result in heavy fines for the firm'.

During 18 March and on the morning of the 19th, a total of 25,000 contributing shares (paid to 20 cents) in Leopold Minerals was sold on five separate orders given in the names of The Client and his wife. In addition, sales of the same class of shares were made on those days for other clients who were not in possession of them, including a syndicate in which The Employee had an interest. The prices at which the short-selling was done ranged from $1.06 to 48 cents. This was a time of speculative expectations about Leopold. The directors had at first announced on 16 March that they knew of no reasons for the upwards movement in the shares' price; then on 18 March the Perth Stock Exchange advised that the directors would make an announcement the next day giving results of assays received from the test laboratories. It was at 12.48 p.m. on the 19th, just after the last short-selling orders on behalf of The Client had been executed that the directors of Leopold reported nickel assays of average 5.33 per cent on a core of 25 feet. The report, though ultimately to be found false, temporarily confounded the expectations of all the short sellers. The price of Leopold contributing shares soared in the next few trading days to as high as $7.80 (on 22 March) while the fully-paid shares went to $8.80 (on 22 March) from a price of only 27 cents on 5 March. When trading in the shares was suspended on 24 March, the price stood at about $4.90 for the contributing shares and $6.20 for the fully paids. In due course, after the suspension was lifted, prices fell back below those at which the original short-selling had occurred, but by then the damage had been done to John T. Martin & Co.

A statement which was prepared subsequently by the investment adviser in the firm's Sydney office whom we have referred to as The Employee gives a graphic version of his relationship and methods of doing business with a short-selling client. The narrative was accompanied by a statutory declaration by The Employee, dated 19 March 1971, to the effect that The Client had placed a specified series of orders to sell Leopold contributing shares. As a matter of general interest the text of the narrative statement is here reproduced, with the substitution of the phrases, 'The Client' and 'The Wife' for the names quoted in the original. With such slight modifications, the statement reads as follows:

I am a client adviser employed in the Sydney Office of John T. Martin & Co.

I have known The Client for approximately 15 years. In approximately July or August 1970 I opened accounts for him and his wife with John T. Martin & Co. These accounts were opened on The Client's instructions. He and his wife traded regularly through John T. Martin & Co. I had no business contact with The Wife (although I have met her) and all orders on her account were given to me by The Client. Contract notes for sales and purchases on The Wife's account were sent to their home addresses to her, and in some cases I believe that transfers would have been returned signed by The Wife.

At no time did John To Martin & Coo receive any payments from The Client and The Wife on the accounts, as all trading was done on credit. Most of the transactions were short term and the accounts were rarely in substantial debit.

Short sales were made on both accounts from time to time. These were done on The Client's instructions. All orders were given to me by The Client on the telephone, and no written confirmation of orders was even sent. I would often speak to The Client six or eight times a day as he took a very active interest in the market. When he gave me an order he would tell me whether to book it to his account or his wife's. I would occasionally call The Client when a report affecting the market was issued, but normally he would call me every hour or so during trading. I sometimes made recommendations to him about the market, but he always made his own decisions. I do not think he was using any other broker during this period.

Other advisers employed by John To Martin & Co. spoke to The Client from time to time when I was out or unavailable, and I believe that they would have taken orders. A total of five orders to sell Leopold Minerals 20c contributing shares were given to me by The Client on March 18 and 19. These orders were as follows:

March 18 a.m.	Sold 5,000 contributing shares on his account.
	Sold 5,000 contributing shares on his wife's account.
March 18 p.m.	Sold 5,000 contributing shares on his account.
	Sold 5,000 contributing shares on his wife's account.
March 19 a.m.	Sold 5,000 contributing shares on his account.

My recollection is that when the first sale order was given at about 11 a.m. on March 15 I had been discussing other matters with The Client on the telephone and he asked me why Leopold has risen in price. I said that it seemed to be "on rumour". The Client said "They seem to be a bit high, we'd better sell a few". He then told me to sell 5,000 contribs, on each of his and his wife's accounts. On the afternoon of March 18 the price had gone up further and at about 2.30 p.m. The Client said to me "We'd better sell some more and average". On March 19 at about 11.30 a.m. the shares had risen further and I discussed it with The Client. He said that he had heard that there was a report about to be issued and asked me what I had heard. I said "There are a lot of rumours". The Client replies "They all fall when reports are announced" and he instructed me to sell a further 5,000 contribs, on his account. I was aware at this time that he did not own the shares and was selling short.

The report was issued by Leopold soon after lunch on March 19. At approximately 2.15 or 2.30 p.m. I was walking to the lift in our office when I noticed The Client at the Reuters teletype machine in the lobby. I said to him "Have you seen the Leopold report?" The Client replied, "I didn't know about it until I saw it on your machine. I'm going back to the office. Walk with me, and we'll discuss it."

I walked back to The Client's office in Street, and we discussed the situation. On the way, he was very agitated and said something like "I shouldn't have sold those bloody things". Later, in his office he said that the first thing he knew about it was when he spoke to me on the telephone that morning. I said "But you sold some Leopold this morning". The Client replied "I didn't put any orders in. You have done that without authority". I continued to argue with him about this, but he denied that any of the sales of Leopold were authorised. I stayed at his office until approximately 4.00 o'clock when The Client had a call from Mr Massey, the Sydney partner of John T. Martin & Coo, to inquire about the transactions. I was in the room when The Client spoke to Mr Massey and heard him deny that he had ordered the Leopold sales. Before he left the office I said to him "... as far as I am concerned, you placed those orders and the stocks were sold with your authority". The Client then left to go to the office of John T. Martin & Co. to discuss the situation with Mr Massey. On the night of March 19 I made a written statement, a copy of which is attached, and made a statutory declaration, a copy of which is also attached. On the night of Monday, March 22, I had a telephone call at my home from The Client who said that I was wrong and he had not placed the orders. I told him that I had been instructed by Mr Massey not to discuss it with him. He said that he had had legal advice and had not been told not to contact me. He then mentioned a group of people he would call to give evidence against me. I do not know what the relevance of that was. The Client was very distressed.

Elsewhere, the Committee noted the severe effects which short selling can have on brokers' financial positions, and the reluctance shown by some stock exchange authorities to recognise the dangers when first questioned about them, until serious trouble overtook a number of Sydney brokers in the Antimony Nickel crisis during the currency of our investigations. In the case of the Martin firm, while the short-selling of clients in Leopold shares was not the sole cause of the firm's collapse, this short-selling does appear to have played a doubly destructive role: first, in directly jeopardising the firm's financial position, and secondly in suggesting to the firm's principals a method of trying to gamble their way out of trouble which promptly had the effect of magnifying the disaster.

As previously mentioned, the Sydney office of John T. Martin had effected short-selling orders in the Leopold contributing shares for other customer accounts as well as those of 'The Client' and his wife of the above narrative. Altogether in those few crucial days preceding the announcement of high nickel assays just after midday on Friday, 19 March, it appears that the firm's clients had short sold about 48,000 contributing shares (but no fully paid shares in Leopold) at an average price of about 60 cents, that is for a total consideration of $28,700. When the assay report produced an enormous lift in the price of Leopold shares, Mr Martin and Mr Massey knew that the firm itself would be required within three days by stock exchange regulations to meet the responsibility for supplying any Leopold scrip which their short-selling clients would not or could not deliver.

This was the extent of the firm's predicament. To 'cover' itself by buying in Leopold contributing shares at the market prices prevailing immediately after the assay report would involve outlays of not less than seven times and up to ten times the consideration received from the short-selling of a few days previously. The firm did not act to cover itself immediately, and paid prices which would involve it in net losses of the order of $200,000.

The Principals' Last Gamble

But John To Martin & Co. went much further than that.

In addition to covering the short sales made by its clients, it can be established that the firm itself as principals made heavy speculative purchases of Leopold shares. It speculated particularly in fully-paid shares, and it paid the peak prices which ruled in the feverish conditions for a few days after the publication of the bogus assay report. The Committee's investigations show that the firm bought 29,550 of the fully-paid Leopold shares in the three trading days of 22 to 24 March 1971, before the stock exchanges suspended trading in the stock because of suspicions about the assay report, and it sold 6,400 of these shares, making a net acquisition of 22,950 shares at an average cost of about $7 each. In addition, the firm traded actively in Leopold contributing shares on its own account on the same three days, purchasing 55,855 of these and selling 25,700, leaving a net balance of 12,155 contributing shares bought at prices between $3.85 and $5.25 and standing at a net average cost (after some profitable resales) of about $2.20 each. Both the scrip records and accounting records show that the firm of John To Martin committed itself to purchases of Leopold scrip involving more than $180,000 in those three days, additional to the comparable amount it committed to covering clients in the same company's scrip.

In explanation of this development, Mr Massey told the Committee how, after 'a very worrying weekend', he and Mr Martin had decided on Monday morning, 22 March, that Leopold shares were likely to go even higher as a result of the assay report, and that therefore they should begin to buy immediately at prices between $5 and $6, 'even though we had to wait until Monday evening before we bought shares and debited them to clients we believed would not deliver the scrip'. But after lunch on the same day, the price went to $8.50. 'After a very worrying lunch' he and Mr Martin came to the conclusion that the shares were bound to react downwards, so they decided to sell in the afternoon Leopold shares which they had bought earlier in the day. Mr Massey's evidence continues:

We were then confronted on the Tuesday morning with the problem all over again that we had 46,000 shares to buy to cover our position with other brokers to whom the shares would have been sold when the accounts were selling. We proceeded to try and buy these shares, and we found that the market was below the price we had sold the day before, but they were extremely hard to buy. In fact our Sydney broker had telephoned us from the floor and said: 'Look, everybody is on to us. There is a rumour around that Martin and Company are short the shares. I suggest you try and buy some through your other Sydney agent. They are very hard to buy'. So we placed orders with the other agent as well.

Senator Wriedt: This was on the Tuesday morning?

Mr Massey: And the Tuesday afternoon. I am not sure as to the actual figures but it certainly was not the required 46,000 shares. On the Wednesday morning we came up with the same problem. We also decided that if the shares were going to take a great rise that we should buy 10,000 or so for ourselves after we had finished buying for clients to help overcome the short term problem that we were obviously going to have which was one of liquidity. It was quite obvious that these clients who had not delivered the scrip were not going to do so, and there would be a considerable time gap between the period when we were forced to pay the broker from whom we had bought the shares and the time when we would seek legal action and finally obtain money from the clients who had wrongly sold the shares. One way of trying to offset this in part was that John (Mr Martin) and I decided to see if we could not make another small profit from buying an additional quantity of 10,000 or so shares and help the overdraft a bit if the operation was successful. In fact we covered all the shares that were short sold by clients and by midday Wednesday, when the shares were suddenly delisted, I found that we had more shares than we had originally anticipated buying, and this had been because of buying the shares through Two brokers as it was so hard to acquire most of the shares. We bought on the Wednesday in the last twenty minutes or so, so I think the selling brokers must have had some indication that the shares were going to be delisted and overall we ended up with 10,000 more shares because both brokers finally bought what they had been trying to buy on the Monday, Tuesday and Wednesday.

Senator Rae: Is there anything which you wish to add?

Mr Massey: No, that is the sad story.

This account by Mr Massey under-states the extent of the firm's speculation in Leopold shares both fully-paid and contributing over and above what were needed to cover the clients' short-selling.

Mr Martin in evidence to the Committee at first maintained that none of the house-account purchases should be regarded as trading operations, but that they had all been made to cover the firm against clients' short-selling (in camera). Subsequently, Mr Martin admitted that the firm had traded in Leopold in the latter part of the period in question (in camera), while tending to suggest that this was a matter of small importance. But even on the first of the three critical trading days, 22 March, the firm as principal had not only bought 19,300 of the contributing shares (the kind needed for direct covering of clients), but also sold 15,100 of these shares at a higher price, in the circumstances to which Mr Massey's evidence referred. It is apparent that a speculative impulse influenced the firm's trading in Leopold throughout the period, taking on massive proportions before the end. Mr Martin offered no explanation of the reasons for the degree of the firm's autonomous trading which he finally acknowledged. A gamble which was evidently intended to recoup the losses sustained as a result of client shorting, had the opposite effect. The house trading approximately doubled the scale of the disaster when Leopold shares were, first, deprived of negotiability during the period of suspension, and then practically destroyed in value by the revelation of false assay reporting.

The gamble by the principals turned the risks of insolvency for John T. Martin into a certainty. Its bank overdraft had been rising rapidly while the clients' trust account was being depleted. On 6 April 1971, when the overdraft was more than $670,000, the bank refused further accommodation and the firm went into default.

Whilst there is as yet no finality, the last available statement of its position by the Receiver-Manager in February 1974 estimates that the deficiency is $1,385,000, or more than $100,000 for each month of the firm's business life. Amounts still owing to clients were $726,914. The position of the clients' trust account is in dispute at the time of preparing this Report. The Committee has received evidence suggesting that there may be a deficiency of more than $400,000, though Mr Martin contests this. The fate of the firm's clients remains gravely uncertain. Yet, as late as 22 March 1971, an audit conducted by the prominent firm of chartered accountants who were Martin's auditors had shown 'no deficiency in trust'.

As to the causes of its failure, one element which has not so far been discussed is the profit or loss incurred as a result of day-to-day brokerage operations, exclusive of bad debts and house-account speculation. It is likely that the firm's ordinary operating expenses substantially exceeded the brokerage revenues throughout its life. Certainly, the audited accounts to 30 June 1970, show that in the establishment period of the first seventeen weeks from 5 March, the firm incurred heavy operating losses of $118,990, which reduced the proprietor's funds, or capital, from $149,361 to only $30, 371; but it is difficult to make comparable estimates of operating results in the subsequent nine months. Of the other causes of failure, the combined losses arising from Leopold, as a result of client short-selling and the firm's buying on its own account, were perhaps not much greater than the losses which were to be finally attributed to bad debts from employees' speculative trading, but the plunges into Leopold shares certainly precipitated the collapse and determined the timing of it.

With this much understanding of the causes of the broking firm's failure, the difficulties associated with any efforts at preventive control will become apparent. First, the true extent of the employee debts was denied by this firm's principals right up to the time of the Committee's public hearings, which may reflect their unawareness of the scale of the debts. Secondly, the short-selling of Leopold and other stocks by clients was accommodated in defiance of stock exchange rules applying to this firm, which evidently proceeded on the assumption (correct up to the time of the firm's demise) that the continuous breach of regulations would be undetected. Thirdly, the principals' own disastrous trading in Leopold was also something that Mr Martin was prepared to deny until an advanced stage of the Committee's examination.

It may be concluded that no stock exchange chairman would have been likely to gain an appreciation of the state of the firm's affairs by inviting the principals around for a cup of tea and a chat, had he been prompted to take that usual method of launching an inquiry into the fellow-member's affairs.

The ACR Phase

It has been shown how Mr Martin's firm combined the roles of share-broking and share-trading. Something remains to be said about his other roles as company promoter and underwriter, as company director and also as an influence in the conduct of companies in which he was not himself a director but had employees of his broking firm acting in that capacity.

During 1970, John T. Martin & Co. promoted and under-wrote four mineral exploration companies which sought stock exchange listing, three of them successfully. In the order of their flotation dates, these companies were Australian Continental Resources Limited (in which the underwriting was shared), Glomex Mines No Liability, King Mountain Mining No Liability and Queensland Antimony No Liability. The first of the companies, Australian Continental Resources Ltd, was floated in April 1970, (soon after the commencement of John T. Martin & Co. as a firm) with a public issue of 46,000,000 in twelve million shares of 50 cents eacho In this case, Mr Martin shared the sponsoring role with a British group, the Tri~nph Investment Trust Ltd. The underwriter of the float was Triumph-Martin & Co Pty Ltd, which was half-owned by the British and half by the Martin interest and at this stage was virtually staffed by Martin employees. Triumph-Martin was also to be the management company for Australian Continental Resources (ACR), and the prospectus for the float said that Triumph-Martin would 'provide the services of experienced and highly competent mining men and other experts'. The three-man board of directors of ACR comprised Sir Walter Michelmore, Mr J.T. Martin and Mr G.T. Whyte, who was the original representative of the Triumph interests of the U.K. and acted in that capacity for a period of some months. Mr Martin on occasions acted as public spokesman for the board of ACR.

Failure to Fulfil the Prospectus' Objectives

Soon after its formation, ACR became a very active trader in the speculative mining share market, and the great bulk of the buying and selling of shares was done through the broking firm of John T. Martin & Co. The Committee's investigations show that in its first eight months' existence ACR's trading through this one broking firm was not less than $4.7 million of which purchases were about $2.8 million and sales about $2 million. In some of the earlier stages of its trading in that hectic and booming share market, ACR was showing substantial realised and book profits on its speculations, but the final result of its trading after about eight months was a net loss of about $900,000, according to Mr Robert Poynton Foot who took over as the Triumph representative and became the managing director of ACR in December 1970. Hence, losses in the share market in that short period of time amounted to nearly one-sixth of ACR's paid capital. The brokerage commissions earned by the firm of John T. Martin & Co. on these trading operations would have been of the order of $90,000 according to estimates given to the Committee. Mr Martin as broker gained large revenues from the severly unfortunate speculations of a listed public company of which he was the key director at that stage because of his experience in local business and share market matters.

The Committee, at an early stage of its inquiries into the affairs of John T. Martin, formed a distinct impression that the prospectus which had been issued for the float of ACR had not given the investing public any reason to expect that the company would engage in highly speculative share-trading, but that it would in fact have conveyed to readers an opposite message of a conservative policy in the management of the company's funds.

This opinion of the Committee's was rejected by both Mr Martin and his partner Mr Massey when it was put to them. Since the general subject of adherence to prospectus undertakings, explicit and implicit, is seldom raised in general financial discussion or taken to be a matter for anyone's professional attention, we believe it is worth setting out the points at issue in a case such as this one. First, we quote the section of the ACR prospectus which described the company's objectives. It reads as follows:

OBJECTIVES OF THE COMPANY AND PURPOSES OF THE ISSUE

The company is being established with a view to exploiting the potentialities for investment in Australian mineral and other natural resources. It will give investors the opportunity of participating, under professional financial and technical management, in t he broad spectrum of the Australian market. The company will have available to it the services of the management company referred to on page 4 of this Prospectus. The prime purpose of the company will be to spread its funds widely among suitable available projects primarily in the extractive industry concentrating mainly on already proven areas. These objectives can broadly be described as encompassing financial participation in mineral development and related projects which have already gone beyond the stage of primary exploration.

The directors believe that suitable investment opportunities will present themselves during the course of 1970 although they cannot at this stage give any specific investment indications. In the meanwhile funds raised by this issue will be invested in the short term so as to generate income. Involvement in substantial projects will only occur after a very thorough and exhaustive analysis of the opportunities involved and the management does not intend to make investments in high risk projects.

It is the advantage of this type of company that it is able to spread any risk over as wide an area as possible over a number of separate mining investments.

A further important part of the company's functions will be to facilitate the marriage of Australian and overseas capital with the objective of ensuring Australian equity participation in worthwhile projects whilst attracting overseas funds in the dimensions required for Australia's continuing development.

There are financial advantages to be gained from providing capital at crucial periods in the development of a mining enterprise. It requires research and investigation at a high level to ensure that rewarding investments are made and the company will be able to undertake such investigations with the assistance of the management company referred to on page 4 of this Prospectus.

A reader of this section of the prospectus sees no allusions to any proposed programme of speculative short-term dealings in the share market. On the contrary, the prospectus conveys a cumulative impression of a sober, long-term approach to mineral outlays by its emphasis on a policy of 'concentrating mainly on already proven areas', by the concern expressed for 'projects which have already gone beyond the stage of primary exploration', by the expressed intention that in the company's early stages 'funds raised by this issue will be invested in the short term so as to generate income', and by yet another assurance that, where substantial financial involvement is concerned, 'the management does not intend to make investments in high risk projects'.

Nevertheless, ACR during its first eight months put nearly half of its paid capital at hazard in the most volatile sections of the share market. That was the real effect of the $2.8 million of share purchases made over the period, even though nothing like that amount was committed to share buying at any single moment; and the scale of the losses so rapidly experienced was commensurate with that overall effect. The Committee has found that ACR's market turnover was mainly in shares which could only have been described at that time, without subsequent advantages of hindsight, as being of a 'high risk' nature, despite the prospectus assurance. Three-quarters of the $2.8 million which was invested in equities during the period went into the following companies (with the biggest amounts committed to individual stocks shown in parenthesis): Australian Capital Development, Acmex Holdings, Amber Gold ($212,595), Archean Mining, Associated Australian Oilfields, Associated Freney, Eastern Copper, Eastmet, General Mining Investments, Genoa Oil ($178,558), Gippsland Minerals, Great Boulder, Hastings Exploration, Hill. Minerals, International Mining Corporation ($268,874 in shares plus $154,299 in options: total $405,175), Meekatharra Minerals, Nickelfields, North Kalgurli, Poseidon ($224,585), Sub-Oceanic Mines, Sundowner, Target, Tasman Minerals, Tasminex ($147,007), United Uranium Exploration, Uranium Nickel and Westralian Nickel ($145,64O).

In addition, ACR made short-term investments in Broken Hill Proprietary, Howard Smith ($158,787), Kathleen Investments, Loloma Mines, Mineral Securities ($129,054) and Western Mining Corporation. But practically all of the companies in the first group of names which have been quoted, comprising the great bulk of ACR's trading activity, had not, to quote the words of the prospectus, 'already gone beyond the stage of primary exploration' and these companies were not paying dividends which could 'generate income' in the short term.

When the Committee raised with Mr Martin and Mr Massey (who had not been a director of ACR) the question of the consistency of this speculative trading behaviour with the professions of the ACR prospectus, both witnesses sought to justify the position without qualification. Mr Massey was questioned first on the matter, and the relevant passage in his evidence reads as follows:

Mr Massey: Once ACR had decided to invest money in short term investments in the market my duty specifically, not being a director of ACR, was to suggest short term mining companies that could be bought and sold for a profit in my opinion. I did give due regard to that duty, which is the normal client-broker relationship, on every occasion when I suggested they buy shares.

Senator Wheeldon: You regard your relationship with ACR as being solely a broker?

Mr Massey: Yes. I was an employee of John Martin & Co. I was not a director of ACR.

Senator Wheeldon: But you had no relationship with ACR different from your relationship with any other company?

Mr Massey: My wife may have o%~ed a couple of thousand shares, as I did. Apart from that there was no different relationship.

Senator Rae: I think from %~at you are saying now and for the sake of the record we should get a little more of the objectives of the company and the purposes of the issue clear. You have just quoted that part which says:

In the meanwhile funds raised by this issue will be invested in the short term so as to generate income.

That does not refer to trading, does it?

Mr Massey: Short-term investment, to me, means trading.

Senator Rae: What! Short term investments mean trading?

Mr Massey: Yes.

Senator Rae: Have you ever heard of the short term money market?

Mr Massey: Yes, I certainly have, Senator, and to me the short term money market would be referred to specifically as inter-company deposits.

Senator Rae: There are other than inter-company deposit transactions which are generally described as the short term money market, are there not? However, it does not matter. It is only what impression one may gain when one reads it. The prospectus goes on to say:

Involvement in substantial projects will only occur after a very thorough and exhaustive analysis of the opportunities involved and the management does not intend to make investments in high risk projects.

Where you are investing in the short term money market or long term, if you are investing in highly speculative shares you are investing in high risk projects, are you not?

Mr Massey: I would think that high risk projects - and the word 'projects' I think is significant - would suggest lending a large percentage of your money to one particular mining venture that may provide a risk. Certainly there are companies that have done that. I cannot recall them offhand but there are companies that have taken a large interest in a venture that has turned out to be a flop. Also, the next sentence I thine should be read within the context of what you have said. That reads:

It is the advantage of this type of company that it is able to spread any risk over as wide an area as possible over a number of separate mining investments.

Senator Rae: Would you regard investing in the highly speculative sector of the stock market as spreading your risk?

Mr Massey: If the company decides to trades in that market in the short term, certainly the manner in which I put forward recommendations to Norman of ACR [Mr R. Norman who was for a time managing director of Triumph-Martin and Co.] was on the basis that we just do not buy one share we buy a number, and I am sure we did follow that.

Chairman (Sir Magnus Cormack): As a Committee we are interested in what I described, and I repeat it, as the fuelling system of the Stock Exchange - where the money has come from and how it has fuelled the system. That is the purpose of asking these questions at the moment.

Mr Massey: I see. Mr Chairman, I would think that if one got an independent view from someone who was qualified in this subject one would find that a great majority of the satellite mining companies that have sprung up during this boom did look upon short term trading in the market to generate expected profits to prolong their lives.

(in camera)

Mr Martin was questioned on the same matter after he had made a statement in his evidence seeking to differentiate between his role as broker for ACR and his role as a director of the company. He began by informing the Committee that it was a board policy of ACR that not more than $2 million of the company's funds should be invested at any one time in 'various short-term investments', by which he meant short-term speculation in shares. Two million dollars is not a small sum to be put at hazard, but in any case, as already suggested, the revolving character of the share investments meant that substantially more than $2 million could be put at risk in a short period of time. The relevant passage from Mr Martin's evidence is as follows:

Senator Rae: What part did you play in any decisions as to investment, bearing in mind that you were a director as well as being a partner in the firm?

Mr Martin: From the firm's side, nothing other than on one occasion I think - maybe more than one occasion - I recommended that they look at an odd stock with a view to purchasing it. From the directors' point of view it was a board decision to invest not more than $2 million in various short term investments which was handled through the Sydney end.

Senator Rae: Do you regard the term 'short term investment' as being the purchase for trading purposes of shares in speculative companies?

Mr Martin: Yes, I would regard that as a short term investment. Senator Rae: What about within the term of the meaning of the sentence used in that prospectus where it says: 'In the meanwhile funds raised by this issue will be invested in the short term so as to generate income'?

Mr Martin: Yes. You see, I think what you are alluding to there is: Would you regard short term trading as a short term investment, so as to generate income? The answer is 'Yes' and if one takes the early part of the mining boom the answer was a very definite and positive yes; in the latter part of the mining boom it was a much more precarious operation; and of course in most cases in the last part of the mining boom would turn negative.

Senator Rae: But where a company is set up for the purposes of investing in specific projects, and where it is anticipated by anybody who thinks about it that the company will have funds which will be otherwise unutilised until such time as they can be placed in those projects, and you describe the way in which they will be utilised in the meantime as short term investment to generate funds, that would not bring to the average persons's mind, would it, that they were going to be used for speculation in the share market?

Mr Martin: I do not think the answer can be a positive one. I do not think you can say that for all people the result would be the same. In the context of the mining boom again and bearing in mind that at the time the newspapers were full of what one mining company had bought in another mining company and so on and so forth, I think it probably would in most minds, and particularly those minds associated with investment or speculation on

the stock exchange at that time - it certainly would have done. It should be borne in mind that of $6 million, $4 million was invested in short term deposits in various areas and $2 million at the most and only for a short period of time was utilised in the share market. At most other times, I would have thought the figure was substantially below that.

Senator Rae: Would you not think it more desirable to spell out quite clearly and in more detail in the prospectus that you intend to speculate with the money by investment for trading purposes in the speculative section of the market?

Mr Martin: I think it is desirable that in any prospectus you go to the greatest lengths you can do as far as detail is concerned but there is possibly a limit to the detail you give at some stage. You would point to that point, other people might point to other points, and with every company it would be different. If we take the speculative mining companies, I think the con, on way of describing the objectives has been to say that the main objective is to explore for various minerals perhaps in a certain area and so on, and leave a statement as to subsidiary objectives vacant.

(in camera)

The Committee, having quoted the explanations offered by these witnesses, in an attempt to reconcile the impression that was conveyed by ACR's prospectus with the investment policies adopted by the company, is obliged to express the opinion that their arguments are unconvincing. The words of the prospectus have already been quoted, and the reader may form his own judgment as to how many ordinary members of the public would have expected speculative trading in non-dividend paying mining exploration shares to be the fulfilment of claims made with a prudential air that ACR's funds would be invested on a short-term basis in ways to 'generate income', when that kind of share buying was always liable to generate disastrous losses, as it did. The only sure income that such a policy would generate was for the broking firm of the two witnesses. Mr Martin contradicts himself in consecutive sentences when he alleges on the one hand that 'in most minds' the reference to a policy of short-term investment for income would have been associated with speculation on the stock exchange, while on the other hand he claims justification for himself by saying that after all a large part of ACR's initial funds was not invested in this way, but was placed on 'short-term deposit in various areas'.

The adoption of double standards extended into another area relating to Mr Martin's dual roles as company director and as broker.

Inside Tips in a Broker's Newsletter

Throughout 1970 the board of ACR and Mr Martin in particular as a member of the board, withheld from their shareholders any hint to the effect that the company's most intensive form of activity had been in speculative share trading. With Mr Martin the broker, however, there was not the same degree of reticence. In fact, the only members of the public who might have been able to form an idea of ACR's share-trading activities at that time were recipients of the weekly newsletters issued by John T. Martin & Co. and headed 'Confidential - For Clients & Correspondents Only'. The following is an extract from the newsletter dated 2 October 1970, issued from the broking firm's Melbourne head office at a time when Mr Martin was still the firm's sole proprietor:

Is Australian Continental Resources Going Places At Last?

The company was listed when the mining market had bottomed and very little interest was generated in the shares. The share price has languished around 40c for some time, and it now appears to be moving upwards with sales at 50c. The renewed interest has been brought about by rumours of a significant shareholding in International Mining Corp., and the possible acquisition of a strategic holding in an industrial company. It is believed that a Press statement will be forthcoming in the near future on the company's progress, particularly in its endeavours to obtain interests in viable mineral ventures. ACR has remained quite liquid and should be able to readily finance workable mining projects. In view of the improvement in the mining share indices, it seems reasonable to assume that at least satisfactory share-trading profits are achieved and this would warrant a higher market rating. At current levels we believe the stock is interesting.

The broker's newsletter thus revealed in print for the first time that ACR had been engaged in 'share trading'. Further, it conveyed smoothly and obliquely a message that the results of such trading would, as a matter of course, be linked to the performance of 'the mining shares indices'. Moreover, there were 'rumours', which a key director of ACR in his other capacity as broker discoursing to his clients and correspondents thought worthy of mention, to the effect that the company had bought a significantly large holding in one speculative mineral company, International Mining Corporation. There was another rumour that ACR would acquire 'a strategic holding in an industrial company'; and the broker who was also a director 'believed' that ACR would before long be making a Press statement concerning its future. The newsletter might thus be regarded as a mine of information by those of its readers who recognised a connection between the broking firm and the company. It came to pass four days later, on 6 October 1970, that an official statement of substantial length was indeed published over the name of one of the company's directors, who signed himself as follows:

Yours faithfully,

For and on behalf of the Board of
AUSTRALIAN CONTINENTAL RESOURCES LIMITED

J.T. Martin
Director

This document was weightier in tone but in some respects far less communicative than the broker's sheet. Mr Martin, the director, wrote at substantial length about feasibility studies and negotiations concerning possible coal mining prospects in New South Wales, about preliminary investigations for alluvial tin development, about other tentative inquiries relating to iron sand deposits in New Guinea and silica sands in Queensland, and he announced that ACR was making a takeoeover offer for the whole of the capital of the Australian Pastoral Company Ltd, presumably the 'industrial company' referred to in the broking newsletter. But the company director's statement did not refer to share trading, let along to the mining share indices or such a company as International Mining Corporation, in which, as we have noted, ACR made total purchases of shares and options costing more than $400,000 over a period in 1970. In this statement there was a fleeting reference to short-term investment in shares, made under the heading of 'Asset-Backing' and reading as follows: 'Directors also report that the asset-backing of the shares is approximately 49c which represents cash on deposit and share investments, mainly of a short term nature. Investment of this type will continue until funds are committed to long-term projects'. No ordinary reader of the statement, certainly including any whose thinking had been conditioned by the previous official statement of policy in the prospectus six months earlier, could have formed an idea of the extent of the company's activity in mining share speculation. Mr Martin's claim in evidence that 'most minds' would have deduced short-term speculative intentions from a reading of the prospectus does not square with his own continuing reluctance to mention it in the company's October report.

On the whole, it may be concluded that the newsletter issued to Mr Martin's clients offered a more realistic picture of what ACR had been doing than did any official communication made by Mr Martin and his co-directors to the stock exchanges or the public. The eompany's official statement of 6 October signed by Mr Martin rather had a function of confirming the broker's newsletter of 2 October at certain identifiable points, tending to impress readers of the newsletter with its access to a useful range of inside information.

The conflict of interests between Mr Martin's roles as broker and director has previously been noted in the context of the large brokerage commission revenues he derived from the company's risky and eventually very unprofitable share speculation, where the 'short-term' character of the investments, which meant rapid turning over of stocks bought, enhanced the brokerage returns. An extension of the area of conflict appears in the advantageous use made of the broking newsletter which might help to stimulate general client business and brokerage revenues, at the expense of standards of realism in the company's formal reports to its shareholders and the public. The references to ACR which were made in the Martin newsletter were highly improper, coming from one with special access to information and being conveyed to a selective readership in the interest of promoting his private business interests. But as far as the Committee is aware at no time until now has the propriety of Mr Martin's newsletter been investigated or questioned by the stock exchange or State government authorities.

The Committee notes here that one of its general findings is that stock exchanges have not exercised any surveillance over the content of brokers' circulars or given attention to the qualifications or personal interests of the persons who prepare them. The exchanges have not considered it necessary to obtain as a matter of course copies of all circulars issued by their members, let alone to keep these for the record. Since the circulars usually carry a disclaimer of liability in common law for defects in the accuracy or soundness of their contents or for any consequences arising out of them, this appears to be an area of peculiarly uninhibited freedom for brokers.

Mr Martin's Other Promotions

Mr Martin sought to associate his roles as a broker and a director of ACR with further activities as a promoter and underwriter of other companies. Mr Foot told the Committee that the firm of John T. Martin & Co. which employed its own geologist, brought a number of mining propositions to the consideration of ACR as possible avenues for substantial investment, and that these propositions included three companies for which Martins would act as underwriter, namely Glomex Mines, King Mountain Mines and Queensland Antimony. This kind of relationship had been part of the original intention in the formation of ACR jointly by Martins and the Triumph Investment Trust of the U.K. Mr Foot, who became the Triumph representative late in 1970, testified as follows:

Originally it was envisaged that John T. Martin would bring mining proposals to the attention of Triumph Martin and so, I gather, from time to time there were meetings at which he would present schemes of one sort or another for the consideration of Triumph Martin and subsequently ACR. None of these came to fruition because none of them were satisfactory. In fact, this was one of the reasons - not the major reason by any means, but one of the reasons - for the breakdown between the two parties, that nothing of any tangible value or substance was produced by the Australian interests. Occasionally members of his staff - I know from having seen the bills - were used to do survey or exploration work on leases which could have been of interest to ACR and then subsequently, as I have said, ACR was billed for the work which was undertaken and, of course, provided with the results.

(in camera)

At a later stage of the hearings, the Committee recalled these remarks to Mr Foot, and proceeded with the examination as follows:

Can we take it from that that you were not in any way impressed by the fact that investment had been suggested by John T. Martin & Co. in Glomex Mines, King

Mountain Mines and Queensland Antimony?

Mr Foot: I was not impressed.

Senator Rae: Why were you not impressed by those prospects being offered by John T. Martin to ACR?

Mr Foot: In my view they were worthless companies. I would have been most surprised if there had been anything worthwhile in them and it was not the sort of investment that ACR should be associated with, apart from the other very important factor that John T. Martin was associated with it ...

(Ev. 1758)

The more that the number of Mr Martin's functions multiplied, the greater became the area of conflicting interests. The geologist employed by John T. Martin & Co. as an investment adviser was engaged on a number of occasions to carry out mineral surveys and sometimes to peg mining leases on behalf of ACR. Mr Martin was thus the broker to ACR, a director of that company, a promoter and underwriter of other companies in which he hoped that ACR would invest, and the direct employer of a geologist who was used at times to carry out inquiries specifically on behalf of ACR. Mr Foot indicated to the Committee his sense of dissatisfaction with the arrangements, explaining this not so much in abstract terms but in terms of the pragmatic results. Referring to the decision reached by Triumph Investment Trust late in 1970 to terminate its associations with the broking firm, Mr Foot said (in camera): 'The decision was taken to buy John Martin out of Triumph-Martin, and it was insisted that he resign from the board of ACR because it was an unsatisfactory partnership. His interests were short term, Triumph's were long term'. Mr Foot said that Triumph had been 'most unhappy with the results of the initial operations in Australia, and it was quite obvious that steps had to be taken to sever the connection'. It was the existence of a powerful and more responsible joint sponsor with John T. Martin & Co. in the promotion and management of ACR that placed increasing restraints on Mr Martin's proposals for that company, and eventually ended his association with it altogether.

The Glomex Phase

Glomex Mines No Liability was the second listed company whose public flotation in October 1970 was sponsored and underwritten by John T. Martin & Co. In this case, the firm was the sole underwriter. The company's paid capital was $1,586,000 comprising 7,547,145 shares of 20 cents fully paid and 7,657,100 shares paid to one cent. Glomex's numerous mineral prospecting applications or claims were all located in Western Australia: the company had been registered in Queensland (in June 1970) and continued to have its registered office in Brisbane; it took Sydney as its 'home exchange' for listing purposes, and was managed from Sydney, was underwritten by a member firm of the Stock Exchange of Melbourne and held its 1972 annual meeting in Melbourne. The geographical scatter of Glomex's background was partly sustained in the manner of Mr Martin's efforts to exert a remote influence over its affairs. Neither Mr Martin himself nor his partner, Mr Massey, became a director, but two employees of his firm, both working in its Sydney branch office, were appointed directors from the start, and since one of them was the chairman, with the right to exercise a casting vote in a board of four members, they effectively controlled its policies. These two employees, Mr Alexander Pitts (the chairman) and Mr Nell Charles Handley, were both persons of substantial experience and qualifications. Each of them held a university degree in economics, as did Mr Martin himself, and Mr Pitts was also a chartered accountant. Mr Pitts had three years' previous experience in sharebroking, and Mr Handley nine years.

Mr Martin, at one point in his evidence, told the Committee that he regarded both these employees as the 'representatives' and the 'nominees' of John T. Martin & Co. on the board of Glomex Mines (*in camera*). Mr Pitts and Mr Handley denied that this was their status. Some of the complexity and ambiguities in the actual working of the relationship will be indicated in what follows. There is no legal provision for nominee directors, and Mr Handley, both in his evidence and in a letter to the Committee (Committee Document 4-1) cited circumstances of his having, as a director of Glomex, acted independently of the broking firm that employed him, while adding that 'with the benefit of hindsight it is clear that an intolerable situation had developed'. The peculiar sway exercised by the Martin firm over Glomex's operations is to be seen in various ways. Mr Martin was a large initial shareholder in Glomex. Through a private family company, EOS Pty Ltd, he held a total of 1,290,000 shares, representing about ten per cent of the number on issue after the flotation. The holdings of Messrs Pitts and Handley, which varied, were comparatively small, as also were the holdings of the other two directors, Mr F.O. Howard and Mr W. H. Jay, who each had engineering qualifications. Mr Martin testified how he had sought legal opinion regarding the status of Messrs Pitts and Handley as directors of Glomex, and his evidence proceeded as follows:

Senator Rae: By the time they came to be appointed to the board - that is Pitts and Handley - you were concerned as to the extent to which they were answerable and responsible to you?

Mr Martin: Yes. Once it was clear that there were two of our people on a board of four people I was concerned as to the distinction between the duties, and I took steps to find out.

Senator Rae: But I presume that you were interested to find out the extent to which they were answerable to you - the extent to which they would be acting in their own private capacity or the extent to which they would be acting on behalf of John T. Martin & Co.

Mr Martin: It occurred to me that like Franco they could find opportunity where they were sent to find service.

Senator Rae: I think that the latter part of that answer is what I was seeking. You regarded them as being sent to serve?

Mr Martin: To perform a duty.

Senator Rae: On behalf of John T. Martin & Co?

Mr Martin: No, to perform a general duty, part of which was on behalf of John To Martin and its clients.

Senator Rae: They have their duty to the shareholders, of course?

Mr Martin: Yes, and we must keep it in context.

Senator Rae: Any director has a duty, but most directors also represent certain sections of the shareholding?

Mr Martin: Certainly.

Senator Rae: The section of the shareholding being represented by Pitts and Mr Handley was regarded by you as being that of John T. Martin & Co. and its clients?

Mr Martin: Yes.

One result of Mr Martin's policy of seeking to have 'representatives' on the board of Glomex was that his own name appeared in the prospectus only in the context of underwriting broker. In the list of directors prominently shown early in the prospectus (page 4), Messrs Pitts and Handley were described respectively as 'chartered accountant' and 'investment manager', with no indication of their positions of employment by the underwriting broker. Later in the prospectus on page 55 near the end of the 'additional statutory information', there appeared a statement that 'Alexander Pitts and Neil Charles Handley are employees of John Taylor Martin who is entitled to commission as underwriter of this issue'.

The Misleading Prospectus

Within a week of its prospectus date, 21 October 1970, Glomex Mines had begun actively trading in speculative shares through the underwriting broker, John T. Martin & Co., though the prospectus had given subscribers no indication whatever that such trading would be part of the company's business. In that document, the company's objectives were described for intending subscribers as follows:

Glomex Mines N.L. has been incorporated with the primary objective of implementing an active mineral exploration and development programme on 101 Western Australian Mineral Claims the Company has agreed to acquire.

It is the intention of the Directors to participate in the search for minerals in Australia over a broad area and, therefore, funds may be employed to acquire interests in and explore other attractive mining prospects. Any opportunities for mineral production will be keenly evaluated.

Six months later, after the collapse of John T. Martin & Co., the share-trading of Glomex done through this firm had totalled $891,925 (purchases $560,390; sales $551,535). The shares dealt in were Antimony Nickel, Arcadia Minerals, Australian Continental Resources, Genoa Oil, Charterhall, Hill Minerals, Hunter Mining and Investment, International Mining Corporation, King Mountain, Nickelfields, Selcast Exploration, Theseus Exploration, Trendex, United Uranium, Western Mining and Zephyr.

As in the case of Australian Continental Resources, these speculative investments were to involve Glomex in serious losses. In their report for the period of approximately 13 months ending 30 June 1971, the reconstituted board of directors have said that 'the net losses incurred on share-trading exceeded the income receiver on short term deposits. After making a substantial provision for doubtful debts, the company incurred a loss for the period before extraordinary items of $117,641'. Of the 'extraordinary items' not included in that figure, the most important was the provision for further losses of $451,658 as a result of Glomex's purchase of a controlling interest in Trendex Mineral Corporation Ltd (now renamed Lemarne Corporation Ltd), a company which is described at length elsewhere in this Report.

These combined losses from investments undertaken in its first six months as a listed company contrary to the intentions indicated in the public prospectus appear to have been about $505,000, representing about 52 per cent of the initial capital of Glomex Mines.

However, the speculative character of the share-trading done through this broking firm is not the most remarkable aspect of it, for in the first weeks of Glomex's existence as a listed company a resolution had been passed at a meeting of the board (constituted and dominated in the manner already described) which had the effect, first, of authorising Mr Handley to take control of $100,000 'for investment through the Stock Exchange by way of trading in public securities and options', and also authorised Mr Martin (though not a director) or Mr Handley to nominate two employees of the firm of John T. Martin & Co. of their choosing to handle the investment, by way of trading, of a further $100,000 of Glomex funds. A procedural framework was thus created where three employees of this broking firm, two of whom would have no formal association with, or responsibility to, Glomex, and all of whom might be considered to be under the influence of the underwriting broker, John T. Martin, were in a position to 'play the market' purportedly in the interest of Glomex shareholders but also creating commission business for their employer, while they were advising clients of John T. Martin as to investment and while they might well be active speculators in the share market on their own behalf, thanks to the climate of indulgence towards employee trading in this firm which has been described.

Shuffling Funds Between Glomex and John To Martin & Co.

The intricacies of the relationship between the broking firm and the company it had sponsored went deeper than this. The Committee was interested to discover evidence of a sequence of rapid exchanges of cheques, each for approximately $100,000, between Glomex and John To Martin & Co. in the early months of 1971. After questioning various members of the broking firm in order to gain an understanding of this phenomenon we arrived at the conclusion that it was an exploitation of the broker-client relationship in order to provide the broker effectively with a continuing line of credit, and that the shuffling of the amount of $100,000 was intended to avoid the broker's responsibility to place the money~ three days after it was received from a client, in the trust account, where it would not be available for the broker's use. The recurring sum of $100,000 was deemed by the broker to take on a new identity for each brief period between shuffles.

The broking firm's attitude can be illustrated by some extracts from the evidence which the Committee obtained in its process of unravelling this matter. The first witness to be questioned about it was Mr A.H. Brown, the accountant of John To Martin & Co.

Senator Rae: ... Mr Brown, looking at a particular ledger account in respect of this client, it appears that on 15 January 1971 a cheque was received from the client for a fraction - some hundreds of dollars, in fact - over $100,000. I will pass this to you in a moment. Am I right in saying that in the normal course of events a cheque received from a client is paid into the general account and only after three business days is it paid to the trust account unless the documents have been delivered in the meantime?

Mr Brown: Yes.

Senator Rae: So it would be reasonable to assume that the cheque for approximately $100,000 received on 15 January was paid into the John T, Martin and Company general account?

Mr Brown: It would have been.

Senator Rae: Would you explain to us- to assist you I will hand you the document - why on 21 January John T. Martin and Company paid to the client $100,000 and on the same day the client paid back to John T. Martin and Company a cheque for $100,0007 I will mark in pencil the particular transactions to direct your attention to them because there are several pen marks. While that document is being examined by Committee members I direct attention to the fact that on 27 January 1971, it appears that again John To Martin and Company paid to the client $100,000 and on the same day received back from the client a cheque for $100,000.

To summarise, on 15 January $100,000 plus a few hundred dollars was received from the client; on 21 January it is recorded as being paid back to the client and received back again - this is all in the general account, not in the trust account - and then on 27 January again it is recorded as having been paid out to the client and received back from the client. Am I correct, first of all, in stating that that is what appears from that particular ledger sheet?

Mr Brown: Yes, that is what appears. I have not checked your dates in running down the list.

Senator Rae: If you would look at them 15 January was the day it was received.

Mr Brown: Right.

Senator Rae: On 21 January there was a payment out and payment back of $100,000.

Mr Brown: Right.

Senator Rae: And the third one which I have not marked in pencil but which you will see is marked in pen further down was on 27 January.

Mr Brown: Yes.

Senator Rae: Would the effect of these transactions be to keep the sum of $100,000 in the general account of the firm rather than it being paid into the trust account?

Mr Brown: I do not think I can really comment on this One. I was acting on instructions from my - I do not know whether it was my principal or one of my superiors in this case, and that is what I have just done, acted on his instructions and arranged these transactions.

Senator Rae: Have you any detail of the transactions as to why they were going out and why they were coming back?

Mr Brown: No, I have not. As I say, I was only acting on their instructions.

Senator Rae: Presumably no auditor would be able to find from the accounts which were kept under your general care the reason either, if you as the person keeping the accounts did not have the information. Is that a fair conclusion?

Mr Brown: May I confer?

Acting Chairman: Yes, certainly.

Mr Brown: If the auditors had brought out this question - I cannot recall whether they did or did not - as I did not have the information first hand I would have to refer them to my superior for him to give the explanation.

Senator Rae: Is not one of the purposes of bookkeeping generally to enable the auditor to be able to audit the books and find out without reference to personal explanation the nature of the transactions recorded in those books?

Mr Brown: May I speak with counsel please?

Acting Chairman: Yes.

Mr Brown: The books of account were there to show the recordings of the transactions, but as to the intricacies of running the business they are shown on the statement in this instance.

Senator Rae: Your answer may or may not be relevant generally to what we are talking about, but I would like to go back to the particular question that I asked. Is it not correct that, speaking in general terms, the objective of keeping the accountancy records is to enable a person, including an auditor, to go to those records and determine the nature of the transactions and to follow through the transactions and to reconcile all the transactions without needing to obtain specific oral explanations as to those transactions?

Mr Brown: In most instances, yes.

Senator Rae: Would you agree that in this particular case an auditor would not have been able to ascertain why these transactions took place unless he obtained some oral explanation? Is that so?

Mr Brown: That is right.

Senator Rae: Would you have a look further down? You will see that on 8 February there was a further exchange by a cheque going out for $100,000 and a cheque coming back in for $100,000. Is that correct?

Mr Brown: I can see the payment for $100,000 but I cannot locate the receipt. Yes, I can see that transaction.

Senator Rae: There is one other one there which I mention for the sake of completeness which is obviously a correction of a mistake made by the ledger machinist and to which I am not referring at all. It is clearly marked as a correction. It is obviously a correction.

Mr Brown: Yes.

Senator Rae: So that there is no misunderstanding at all, the ones that I have referred to exclude that particular one which is shown to be a correction and is obviously a correction.

Mr Brown: That is right.

Senator Rae: Is it not correct to say that the effect of the transactions to which I have referred of 15 January, 21 January, 27 January and 8 February was to keep funds in the general account of John T. Martin & Co. which would otherwise have been transferred to the trust account?

Mr Brown: It had that effect but I - yes, it had that effect. If I may continue that explanation, that would be correct but it would depend also on whether or not the funds should or should not have been transferred to the trust account.

Senator Rae: And that question is one which cannot be determined from an examination of the records kept so far as the accountancy section of the business was concerned?

Mr Brown: That is correct.

(Ev. 1426-28)

The whole question of procedures for the supervision of client trust accounts in broking offices, to which Mr Brown refers is one of great public importance, in view of the scale of deficiencies which have been revealed in the cases of a number of failed Melbourne brokers. Our general inquiries show that the task of administering and keeping records of trust fund obligations to clients present difficulties in many broking firms, because of the numerous daily transactions. The broad procedures that were formally adopted in John T. Martin & Co. do not appear to have differed markedly from those in some other offices, but we were unable to find a focussed responsibility for the maintenance of a correct balance between the funds held in trust account and the firm's commitments to its clients. While Mr Brown testified that his responsibility did not extend to examining the adequacy of the funds held in trust, but that the required amount was something on which he took verbal advice from his firm's settlement department, other evidence given to the Committee indicated that the settlement department did not follow in detail the course of trust account obligations to particular clients. Mr R.B. Gray, who was in charge of settlements, said that no separate ledger was kept in the name of individual clients in respect of the trust account. He said:

I advised Mr Brown each day of amounts paid into or out of trust. I only advised him the composite total and not the individual items which go into trust account, and therefore you cannot identify. It is just that the trust account is increased or decreased by a total each day which is made up of a number of items.

(Ev. 1436)

In this mechanical recording and notifying process, as between Mr Gray's and Mr Brown's departments, there appears to be not only an absence of focussed responsibility but also little scope for checks and disciplines on transactions between the broker's general and trust accounts at the bank. This is a difficulty in other broking offices also.

The awareness of Glomex itself, the client concerned in the case we have been describing, was likewise dim and uncertain as to what was going on, according to the claims made by Mr Pitts, the chairman of Glomex, and Mr Handley, another director, though they were both employees of the broking firm which was carrying on the shuttling exercises. Thus, when Mr Handley was asked about the purpose of the series of cheques for about $100,000 made out by Glomex, he said: 'I do not know the purpose. I did not instruct the drawing of the cheque or any of the cheques'. However, Mr Handley proceeded to say:

I countersigned most of the cheques, I think. On this specific day my memory is hazy, but I can recall a cheque for $100,000 being put in front of me. I can recall inquiring what this was about and I was told that it had been arranged by the assistant-secretary. I inquired further and said: 'What is it about?' and they said: 'The assistant-secretary has arranged to switch' - or 'exchange' I think it was - 'cheques with John Martin'. I said 'Is this all right? Why are we doing this? 'He said that it had been arranged by the assistant-secretary and in his opinion there was no problem. I said: 'Is Glomex at risk?' He said: 'No.' I said: 'All right'. I think I might have rung the assistant-secretary - I am not sure on this - and spoken to him and was told the same thing. So to my satisfaction as Glomex was not at risk I signed the cheque. At that time that is all I can recall. As a result of what I read in the paper I asked the assistant-secretary to turn the cheques up, which he still has not done. That is six weeks ago. The bank is having trouble finding them it seems. I have subsequently asked him again whether Glomex was at risk and he said: 'No'. So, as I say, at the time I made due inquiry and I felt satisfied we were not at risk.

(in camera)

Having obtained this confirmation from Mr Handley that he had been a signatory of most of the $100,000 cheques made out by Glomex in the shuttling process, the Committee asked him whether he had also signed any of the offsetting $100,000 cheques on behalf of John T. Martin & Co. The evidence continues as follows:

Mr Handley: I do not know. I honestly do not know. There is a chance I could have because, as I say, I countersigned a lot of their cheques, although I have always told them that I would not be first signatory, only a counter-signatory, and I would do a spot check on the cheques I was signing, but I would not check every single cheque because I did not have time.

Senator Rae: But I presume that if you saw a cheque placed in front of you of $100,000 and payable to a company of which you were a director, namely Glomex, you would pay more attention to it than if it was one made out to some other client.

Mr Handley: I would pay attention to it, but I think Martins were drawing cheques for $100,000 every day or so. For example, they had to pay their agent - Hepworths - every day and often the cheques were for over $100,000 and often I would be the counter-signatory.

The air of surprise and limited acquaintance with the details of Mr Handely's evidence, and the impression it conveys that Glomex's directors were not consulted about the cheque-shuttling ritual which prevented their ~100,000 payment to John T. Martin & Co. from being placed in the trust account, but that rather the initiative and direction came from master-minds in the broking firm's Melbourne office, seems to be supported by the evidence from Glomex's chairman, Mr Pitts, which was given immediately after Mr Handley's testimony.

Senator Rae: Mr Pitts, you have heard the questions I have just been asking Mr Handley in relation to the transactions in respect of $100,000 between Glomex and John T. Martin & Coo Are you aware of these transactions?

Mr Pitts: Yes, I am aware of them. They have been brought to bear more consciously since the Press reports and I can speak in hindsight on the matter. I think I, too, was a signatory to probably at least one of the Glomex cheques. One did inquire as to the validity of these. One was assured it was fine.

Senator Rae: By whom?

Mr Pitts: By a representative of the secretary.

Senator Rae: By the representative of the secretary.

Mr Pitts: The secretary's representative, right, who used to bring in cheques from time to time. I understood two things: One that the secretary was part of the management team and in fact looked after all our administrative affairs. There is no question of any suspicion or doubt because it is a fairly reputable firm and certainly a firm that has a great deal of integrity. I did find out simultaneously that there was an exchange situation and there was a multiple number of these cheques. As soon as I found out I phoned Melbourne and I spoke to either Kruse or Martin and I said: 'What's going on here? I understand the Glomex side is all right. Why is this happening?' I was told it was all in order, and there was no reason for me to suspect this because I was told everything was fine. I subsequently was able to establish with the signing of the first cheque, Glomex owed John T. Martin some money, and it appears that the secretary made an arrangement so as not to withdraw funds from deposits but to facilitate with John T. Martin or a representative of John To Martin to exchange some cheques. In this way it proved beneficial to Glomex, in the sense that Glomex earned interest on some $60,000 or thereabouts which was still on fixed deposit, and payment was not made. My concern was the Glomex concern, because this has public shareholders in it. But I think following my inquiry all cheques ceased of this type.

(in camera)

It would appear from this evidence that neither Mr Pitts nor Mr Handley, who collectively had voting control of the Glomex board, ever saw a need to question fundamentally the prerogative of the head office of their employer, John T. Martin & Co., to make arrangements without consulting them for obtaining a continuous loan of $100,O00 from Glomex for the broking firm's business use.

Mr Martin himself, however, gave the Committee a different account of the origin of the shuttling cheques. While he, too, professed not to have a close knowledge of the transactions, saying he had 'passed the problem down the line to be resolved' (Ev. 1458). Mr Martin said that the broad arrangements had been agreed upon in advance by a Glomex director who was employed in his firm. The relevant part of his evidence reads:

The transactions were the results of agreements reached independently between the parties, and in particular I feel that there should be no suggestion that the client was financing the firm, for indeed I believe that the whole series of transactions arose because the reverse was the situation, and that is that the firm was financing the company.

Senator Rae: So far as that particular client was concerned, you have said that the transactions were as the result of a specific arrangement made between the client and your firm. Am I correct?

Mr Martin: Yes. It was not a specific arrangement made on day one to last until day sixty. It was an arrangement from time to time.

Senator Georges: Why did the figure remain the same, at $100,0007 Why was there not variation in the amounts that moved backwards and forwards?

Mr Martin: Eventually there was, but it took some time to reconcile the account to a position where the exact amount could be determined. My recollection was that that exact amount was in excess of $100,000. But as it was considered, by recollection rightly so, that the firm was financing the client through this particularly involved series of transactions, the client in fact agreed to put the firm in funds for a part of that money which the firm considered it was out of funds. Is that clear?

Senator Georges: Not quite, but I will not pursue it at the moment.

Senator Rae: I would like you to write down the name or names of the persons acting on behalf of the client who made the arrangement to which you refer.

Mr Martin: I am not sure precisely the total number of persons involved in making that arrangement. I merely asked one of the directors to make some arrangement with the company to alleviate the situation, and that arrangement was made. As to who he discussed it with, I cannot answer.

Senator Rae: Did the director with whom you spoke discuss with you, or you discuss with him, that there would be this series of withdrawals and repayments by your general account?

Mr Martin: No, because in the discussion which I had briefly with that director - and then the discussion was continued with some other member of the staff and that director while they argued about the resolution of the transactions - it was considered that we would in fact resolve it within a short number of days. This, however, was not the case, and I am not confident that the matter is even yet one hundred per cent resolved.

Senator Rae: So the reason for the initial payment to your firm by the client was that you were of the view that you were financing the client to a considerable extent, in excess of $100,000, and you wanted the client to put you in funds to cover the extent of the credit which was being given?

Mr Martin: Very definitely so. I would make one further point, and that is that the client did, in the series of conversations that I have alluded to, agree that that was so.

Senator Rae: That was the next point I was going to make. This was the starting point, the point that I made a moment ago. The second thing is that the client agreed with that proposition and the net result was that the client made available, by payment in to your firm a sum of $100,000?

Mr Martin: Yes.

Senator Rae: The next stage, as I understand it from what you are saying, is that it was expected that the exact details of the transactions would be known within a short period of time?

Mr Martin: Yes.

Senator Rae: The next stage is that they were not determined within a short period of time?

Mr Martin: Yes.

Senator Rae: And in fact extended over several weeks and may still be not finally resolved?

Mr Martin: Yes.

Senator Rae: And the next, as I am understanding it - not from what you have said, but from what I have seen in the documents and from what you have said - was that in relation to the amount of money paid by the client for the purposes you have mentioned, that money could be kept in the general account of the firm and that particular method of payment out and back again on the same day was adopted.

Mr Martin: Yes.

Senator Rae: So that what you are saying is that it did have the effect of keeping that money in the general account and not in the trust account, but that was not a matter to which the client could take exception because the client intended that that money should be kept in your general account.

Mr Martin: Yes. The client agreed that the money was due and payable. The exact quantity of money was not known, but it turned out to be greater.

Senator Rae: But, nevertheless, what you had to do to be able to observe the rules of the Stock Exchange and of the legislation in Victoria governing the operation of stock brokers' businesses was to go through the motion of paying it out and paying it back in again over a few days.

Mr Martin: I think you will see from the transaction that it was six days or more between the first payment and then the first exchange, and I was aware of the first exchange. I must say that I was not aware that it continued thereafter for another two occasions was it, or whatever it was. But I had passed the problem down the line to be resolved, and when Dr Rose, I think, showed me the document originally some weeks or so ago I was not able then to recall precisely what had happened in the matter, and I was surprised to see the total number of entries, and I suggested to him it was probably wrong. As you know, part of it was but not all of it.

Senator Rae: One in four was wrong.

Mr Martin: Yes.

Senator Rae: The one which we mentioned earlier in the evidence today was a clear correction.

Mr Martin: Quite.

Senator Rae: The other three were apparently payments out by your firm to the client and payment back in again by the client on the same day so that the effect was achieved of keeping $100,000 in your general account.

Mr Martin: Yes.

Senator Rae: And had that procedure not been adopted, under the rules as they apply to the keeping of accounts you would have had to put it into your trust account.

Mr Martin: Yes. I would also mention for the purpose of clarity that had it been any other client involved in a similar difficult and involved series of transactions as that was, then I would imagine the same sort of system would have been adopted. Certainly we would have looked for some relief. As I think you are well aware, brokers work on a fine margin, and the payment of overdraft amounts of that nature could certainly mean that instead of making a profit on such a transaction you assuredly made a loss...

Senator Rae: I would still like you to write down the name of the director with whom you had the discussion to which you have referred.

4.56

Mr Martin: Yes.

Senator Rae: Thank you. That person is in fact an employee of your firm, is he not?

Mr Martin: Yes.

Senator Rae: So we are quite clear: The director of the client company with whom you had a discussion was also an employee of the firm of John T. Martin & Co.

Mr Martin: Yes.

(Ev. 1437-38)

The Committee finds it hardly possible, and hardly necessary, to adjudicate between the conflicting versions given by Mr Martin and his two employees as to whether there had been prior agreement on the use of the cheque shuttling device. Mr Martin's attempts to justify the practice on the ground that Glomex owed his firm money prompt obvious questions as to why such a debt was not paid in the usual straightforward fashion and why the elaborate process of concealment even extended into the early stages of the Committee's inquiries into the matter. To any employees who had a knowledge of what their principals were doing, the shuffling of cheques was not something to inculcate standards of respect or responsibility towards client trust account obligations in general. There was evidently an implicit assumption also that the procedure was not likely to be questioned by the auditors or stock exchange accountants. The general state of expectations in that regard seems to have been expressed by a senior employee when he was asked about the circumstances of a parcel of scrip worth more than $100,000 which lay undelivered and forgotten in a drawer in the Sydney office for nine months. 'In many cases', he said, 'the auditors from whom I have had experience at two broking firms [in which he had worked] have literally not been qualified, and do not really know what they are looking for, and they can be led around by the nose...' (in camera)

It has been shown that the listed company Glomex, even more than its predecessor, Australian Continental Resources, was used as an instrument to promote the Martin broking business in a variety of ways, though the prospectus and other public statements gave no indication of this. The catalogue of petty ambiguities, camouflage and unctuous misrepresentation in the evidence of Mr Martin to the Committee is being presented at some length because it serves to demonstrate the difficulties that would be likely to defeat any system of informal inquiries or 'club-style' monitoring which sought to arrive at the facts. Only a body clothed with statutory powers of direct investigation could be expected to penetrate to the truth The catalogue will now be extended a little further.

The Incursion into Genoa Shares

A common thread running through the early histories of Australian Continental Resources and Glomex Mines was the sustained effort of the Martin firm to gain control of Genoa Oil No Liability, a Sydney-based company formed late in 1968 under separate auspices and having the stated object of engaging in oil exploration. Genoa Oil had soon sponsored the formation of another exploration company, Hartog Oil No Liability, and the Genoa-Hartog group had made a number of forays to gain control by means of 'first come, first served' bids of other new companies whose shares came on to the market at prices below their cash asset backing in the spate of oil company flotations at about that time. Nevertheless, this group had generally conserved its cash resources, refraining from speculative share turnovers. Its cash holdings were the object of the Martin group's interest. Mr Handley, who claimed to have first suggested the idea that ACR should buy into Genoa, told tile Committee: 'I was very interested in the stock with a view to an acquisition because it was the key to $10 million. There were about six companies in it, and it was the key to a number of companies' (in camera).

The newly formed ACR began to act on this strategy in June 1970, and in the course of three weeks it acquired more than 500,000 of the contributing shares in Genoa (paid to 20 cents each), at prices between 15 and 17 cents. The buying over the next five months continued at similar prices until the holding in Genoa totalled 1,152,000 shares. At this point, however, Mr R.P. Foot, representing the Triumph interests, moved into executive control of ACR and decided that the policy should be reversed. 'I made the decision to sell Genoa', Mr Foot told the Committee, 'because I felt that the chances - anybody's chances - of taking it over were slim and it was not the sort of business for ACR. The policy was to get out of the portfolio and get on with the job. It was a big block of shares which we could sell in a hurry when Massey rang up and said: 'I have a buyer for them' (Ev. 1755).

In fact, the telephone call from Mr S.H. Massey had been preceded by several discussions concerning the implementation of ACR's intention to dispose of the Genoa shares, and Mr Foot says he had eventually agreed with Mr Massey that ACR should accept a price of 15 cents a share~ which was two or three cents below the average price it had paid for them. He gave instructions to Mr Massey, as broker for ACR, to sell at that price. Mr Foot's account of the transaction continued as follows:

At the time he rang me and said 'We have a buyer for your parcel of Genoa shares', I said to him 'It is a lot of shares for someone to buy. Who is it?' thinking that perhaps if there was some other likely takeover bidder for Genoa it would be sensible to hang on to the shares a little longer in case they went up in price. He said, 'I cannot tell you who the bidder is.' I thought about it for a day or so and then, as I have said, I looked at the price ACR paid for the shares. It was a falling market and it seemed to me that 15 cents was a reasonable price for moving such a large quantity. So I gave him instructions to sell the shares, still not knowing who the buyer was. Subsequently the shares rose in price.

(Ev. 1753-54)

But the buyer whose identity could not be revealed to AGR because of John T. Martin & Co's sense of broking propriety was none other than Glomex Mines. When Mr Foot learned the identity of the buyer he was 'very angry about it' (Ev. 1755-4), 'It seemed to me that it was a sort of inside deal' he said in evidence (Ev. 1755)o In all the prior conversations he had held with Mr Massey, he had believed he was simply dealing with his broker-agent and discussing with him what was the best price that could be obtained. He had assumed he ~as getting disinterested advice on that level. At no time before the sale was finalised did he receive any other indications. 'Whatever were the causes of the Genoa market's preceding weakness and subsequent strength, Mr Foot was chagrined to find that the price of the shares 'went up immediately after we had sold them, and one found that they had been bought by another company which was associated with the broker through whom one had sold them' (Ev. 1755).

The disposition of the Martin firm's human resources for this relatively minor operation repays a moment's notice. Mr Martin himself was still a director of ACR, the seller, when his broking firm negotiated and executed, for a commission, the sale by ACR of the 1,152,000 Genoa shares. Mr Martin thus had a responsibility to ACR shareholders. While Mr Martin was not a director of Glomex, two of his employees were, and Mr Martin was a major shareholder in Glomex and therefore had a major interest in the buyer, as well as being its power behind the scenes. Meanwhile, Mr Massey, being a director of neither company, considered himself able to conduct negotiations about the selling price with ACR, exhibiting a highly developed sense of broker's protocol in protecting the buying client's privacy, notwithstanding that Mr Massey was Mr Martin's closest colleague and partner, and was the co-employer of Messrs Pitts and Handley and their direct principal in the Sydney office. Acting behind the lattice of normalcy and propriety, which was unchallenged and virtually unchallengable in the circumstances, Glomex had placed itself in a favourable position to make a quick profit, and this was soon to be realised in another unorthodox stratagem which will be described. But the stage in the process by which Genoa shares were transferred from ACR to Glomex illustrates how Mr Martin's deployment of subordinates and his preference for indirect methods of control, so far from reducing the conflicts of his responsibility, enabled the conflicts to proliferate and to be privately resolved to his advantage and the disadvantage of clients of his broking firm.

Before following the Genoa takeover attempt to the conclusion, it may be recorded that ACR's tribulations arising from the association with John T. Martin & Co. did not end with the share deal which has just been described or with Mr Martin's departure from the ACR board shortly afterwards. ACR had the further misfortune of entrusting to Martins the final job of selling, as its agent-brokers, the bulk of the portfolio of speculative shares which it had bought in 1970o In the re-selling process, Martins failed to pay ACR anything like the full proceeds of the realisations, and since the broker has gone into default the prospects of recovery are doubtful. Mr Foot told the Committee in July 1971, that the amount then owing by Martins was approximately $266,000. An amount of that order had been outstanding for well over a month before John To Martin & Co. was suspended in April 1971, and it was Mr Foot's understanding that none of this money had been placed in the client's trust account.

Mr Foot also explained how his very sense of dissatisfaction and distrust of John To Martin & Co. had induced him to put ACR's last selling orders through that firm rather than another one. He said:

Of course, one did not know then that the money was not in the trust account. Martin had a substantial debt to ACR, which had arisen through the sale of shares through John T. Martin & Co. These shares had been sold through John T. Martin & Co. because a lot of scrip had been held by him, and to make the sales quickly it was easier to make them through him rather than have to try to obtain all the scrip out of John To Martin, because a lot was held by nominees.

(in camera)

Misleading the Market in a Purported Takeeover Bid

On the Genoa takeover front, events moved fast after Glomex acquired the 1,152,000 shares from ACR on 7 December 1970, at a cost of almost $150,000 (excluding brokerage and stamp duty). Over the next fortnight, Glomex was an active market trader in Genoa's shares and options as both buyer and seller, but coming out on balance as net buyer. An examination of Glomex's records shows it as having bought 408,000 Genoa shares and sold 214,000 between 8 and 22 December (inclusive), with the price tending generally to rise over the period, and ranging between 13 cents and 21 cents. After that came a swift, concealed sale of the holding in Genoa in circumstances which were ostensibly associated with a first-come-first-served bid to buy large additional quantities of Genoa's shares and options. This pretence to be buying while they were selling was carried out through a new-born subsidiary of Glomex having a paid capital of two dollars. The subsidiary, which was named Belinda Pty Ltd, was incorporated in New South Wales on 24 December 1970.

Ambiguities are to be found throughout the evidence relating to this concluding phase of the exercise in Genoa shares. A study of the pattern of Glomex's trading in the first fortnight after the acquisition from ACR despite the net buying balance could be consistent with attempts to bear down or at least restrain the market price of Genoa while seeking to increase Glomex's holding. That is to say, the selling tended to be concentrated, at least after Wednesday, 9 December, into bigger and more spaced-apart sorties than the buying was, and the prices at which Glomex sold Genoa were regularly and distinctly below the prices it paid for Genoa during that fortnight. (A daily summary of Glomex's transactions in Genoa shares during December 1970, and early January 1971, is contained in Committee Document 4-2.)

Mr Handley, who seems to have played a leading part ix the Genoa exercise, told the Committee he had become concerned that the market price of Genoa was being taken too high, and suspected that this was a defensive tactic on the part of the Genoa directors. In the following passage of his evidence, Mr Handley traced his problem back to the time of Glomex's acquisition of the 1,152,000 shares from ACR;

Unfortunately the sale was quoted on the stock market. Straight away, I suppose, the directors saw it and they were alive to somebody possibly having a go at trying to take them over, so that was not a very smart move as it turned out in retrospect. Now, in fact:

Senator Rae: Perhaps we may pause here. Properly reported?

Mr Handley: Oh, it was properly reported, yes.

Senator Rae: The reporting was proper; it was in accordance with the rules of the Stock Exchange?

Mr Handley: That is right, but my point there was that to see one million shares go through in your stock makes you think: 'Hang on, what is going on' and unfortunately that occurred, and I suppose it had to occur, and I think it made the directors alive to the position that they may have been vulnerable. The situation then progressed to where we asked to see the directors and we went out and had a meeting with them. I think it was on 25 December. We asked to have representation on the board and they were not at all prepared to do so. In fact, before we had the meeting - that is right - Genoa made a placement of ten per cent of its capital to Hartog in return for some claims which we were not happy about because it could be said that the directors were thereby placing ten per cent of the capital of Genoa into another company they controlled and this would make it that much harder for us to gain the control that we sought. Anyhow we had a talk with them. We did not get anywhere. We were in two minds really. One minute we wanted to proceed; the next minute we did not. Very close to the day we met directors - I am not sure whether it was the day after or the day before - the market in that stock jumped 6 cents on the day.

(<u>in camera</u>)

Mr Handley also said he had believed that Genoa's broker was controlling the market in Genoa so thoroughly that it was impossible for Glomex even to sell the shares at prices below the level which the other broking firm had set.

Glomex then tried to break the alleged grip on Genoa's market by trading mainly through broking firms other than John T. Martin & Co. to help disguise the trader's identity. It still played the roles of both buyer and seller, but from 25 December onwards the selling predominated. One Sydney broking firm, Garrett, Lance & Co. refused a request to sell Genoa shares on Christmas Eve and later told the chairman of the Sydney Stock Exchange that Glomex had instructed it to try to 'push the stock down'. The senior partner of that firm, Mr David Lance, wrote as follows in a letter to the chairman dated 21 January 1971:

On 24th December, 1970, between 9.30 a.m. and 10.00 a.m. Mr Alec Pitts, who is the Chairman of Glomex and I think employed by John T. Martin & Co., rang my partner, Mr G.E. Lenzner, to ask whether we had any particular interest in the Genoa market. Mr Lenzner asked him why and he stated that they had noticed that we had been trading in the stock. We stated that we had no particular interest and that any transactions were just normal client type dealings. He then said that he would bring to the phone Mr Neil Handley a fellow director of Glomex Mines.

Mr Handley asked whether we would take a selling order in Genoa for 20,000 shares with the possibility of the order being increased. He stated that a condition of the order was that the shares were to be sold at 12.50 p.m. on that day with no more than 5,000 to be sold to any one buyer on the trading floor. We were told to try and push the stock down.

Mr Lenzner immediately queried the nature of the order. From memory, he believes he said, 'what do you wish us to do if there is only one buyer in the stock who is a buyer of more than 5,000?' Mr Handley then stated that other brokers would be trading in the stock at the time and that he would be speaking to us later in the morning.

Mr Lenzner was concerned with the implications of this order and immediately raised the subject with me. We both agreed that we were not prepared to transact business of this nature. Within five minutes of receiving the order, Mr Lenzner telephoned Mr Alec Pitts advising him that we were not prepared to accept the order.

Mr Handley, when invited to comment on the Garrett, Lance report, told the Committee: 'I do not agree that I said we would try and push the stock down ... But it is true that I asked them to sell, I think 20,000, and at a time and in 5,000 and not more than that to any one - No, I did not say to any one buyer, but not more than 5,000oo.' (in camera). Mr Handley said it was felt in Glomex that the only way they could sell their shares in Genoa 'at what we considered to be inflated prices' would be to let [the broker] who was believed to be acting for Genoa directors 'think it is not us selling' (in camera).

On Christmas Eve, despite the rejection by Garrett, Lance, Glomex managed to sell 316,000 Genoa shares through another Sydney broker while buying 66,000 of them through John T. Martin. On the same day it incorporated the subsidiary Belinda Pty Ltd which was soon to be a player in a bigger selling-while-buying operation.

Soon after the close of trading on Thursday, 31 December 1970, the Sydney Stock Exchange and Press and other media were informed of an offer by the unknown company Belinda Pty Ltd, to buy one million Genoa contributing shares at 19 cents each plus one million Genoa options at five cents, all 'on a first-come-first-served basis'. The circular to Genoa shareholders announcing the offer bore the date of the previous day, 30 December. Belinda's directors, Messrs F.0. Howard, N.C. Handley and D.N. Scott were named without indication that any of them were connected with Glomex or Martin.

Trading in Genoa shares on 31 December had been marked by heavy selling, especially in the last quarter of an hour. The Committee's investigations have established that the predominant seller on the day was Glomex. Through John T. Martin and other firms it had disposed of no less than 1,041,000 Genoa shares in the day, (see Committee Document 4-2). The sales were at prices between 16 and 21 cents, averaging well above the average cost of 13 cents at which a similar quantity of shares had been obtained from ACR earlier in the same month.

The question arises as to why Glomex should seek, or profess to be seeking, to acquire a million Genoa shares to exercise control of that company, precisely when it was selling that number of shares at a similar price in the market. There is a contradiction in the two processes. Neither Mr Martin nor Mr Massey appears to have been told in advance of the 'first come' bid, or been a party to it, and the explanations given by witnesses who devised the bid are not consistent with all the facts.

Three observations seem to be relevant to the question. First, there is the profession by members of the Glomex Belinda group that they had not expected to sell so many shares on 31 December before the first-come offer became publicly known. 'On that day', Mr Handley told the Committee, 'We did not expect to sell many', because of the alleged tactics of Genoa's brokers who 'had not been buying from us' (in camera). At the same time Mr Handley sought to deny that the heavy sales of 31 December were an attempt to depress the price of Genoa preparatory to the first-come bid, by arguing that the price had been 'inflated'. Mr Handley's explanation to the Committee expanded to include a desire on the part of the Martin organisation to spread the well being. 'We felt', Mr Handley said, 'that we had sold quite a lot of shares at an average of about 20 cents, and it was only fair that we should give shareholders a right also to sell some to us' (in camera) o There are difficulties in accepting these professions at face value. If Glomex had not intended to sell so many Genoa shares, it need not have placed provisional orders to sell that quantity, and it could have checked the rate of disposal after it had observed the market's absorption capacity during the day.

More fundamentally, a serious bidder for control of the Genoa group's cash resources (estimated by Mr Handley to be $10 million) would not have regarded a price of around par for the 20 cent-paid shares as inflated. Genoa Oil had 16 million shares on issue. The 1,152,000 acquired by Glomex early in December 1970 fell short of a controlling interest, though it was thought to be about equal to the number at the disposal of Genoa's directors. The addition of a further one million shares and a million options to Glomex's original holding could have been decisive in giving control. But for somebody to sell 1,000,000 Genoa shares at an average price of approximately 19 cents with a firm intention of buying 1,000,000 shares at that price tomorrow (literally, the next day), when the money involved for a million-shares deal either way (about $190,000) is very small by comparison with the cash resources going with control of the company, does not make commercial sense.

The second consideration is that the Glomex directors were so little disposed to admit openly what they were doing at the time of the Belinda bid that they resorted to a false statement when the directors of Genoa Oil accused them of having been heavy sellers of the shares on New ¥ear's Eve. The exact status of Belinda as a wholly owned subsidiary of Glomex may not have been Known to the board of Genoa Oil on 5 January 1971, when it issued a circular to its shareholders advising them not to accept the first-come bid. The Genoa directors said that the market price of their shares had been depressed by someone's heavy selling on 51 December, just before Belinda's bid, and that 'the turnover on that day on the Sydney and Melbourne stock exchanges was over one million units'; therefore they felt obliged 'to publicly ask the board of Belinda Pty Ltd to state whether or not Belinda Pty Ltd, or its associates, were identified or connected with the seller, and whether Belinda or its associates have sold any Genoa shares on that day or either prior or subsequent thereto'. A fortnight later, in a circular letter dated 19 January, the Belinda directors replied in these terms:

The Directors of Genoa imply that Belinda Pty Limited or its associates sought to improperly despress the price of Genoa shares towards the close of trading on the Sydney Stock Exchange on December 31st, 1970, by offering approximately one million units for sale. The Directors of Belinda emphatically deny this implication, and state that although shares have been sold by associates of Belinda, these were sold during a period exceeding one week at prices considered to be inflated.

The Committee has already stated its findings that Glomex did sell more than a million Genoa shares on the day in question. The public was being deceived about circumstances surrounding the bid - circumstances which had a bearing on its genuineness as a bid at all. The false denial was made with complete immunity from correction. There were other sophistries in Belinda's statement. Glomex was something more than an 'associate' of Belinda; for practical purposes, they were identical. Why Belinda had to be brought into existence at all as the bidder is a question that seems answerable only in terms of an unwillingness on Glomex's part to admit its role as a heavy seller of Genoa at the time when it was promoting a bid, or the atmosphere of a bid. As a listed company, Glomex would have been required to advise the stock exchange that it was the effective bidder for Genoa shares, but it did not so advise. The circumstances of Glomex's unloading of Genoa shares thus maintained the same air of subterfuge behind implied claims to legal distinctions as were noted in the circumstances when Glomex acquired the shares in the first place from a misinformed ACR management.

A third consideration in seeking the motivation for the final Glomex/Belinda operation is that in the event Belinda did not seriously press Genoa shareholders to sell. Mr Handley went so far as to claim in evidence before the Committee that: 'If you look at our letter you will see that we asked for proxies rather than shares. In fact, when people rang up to sell to us, our fellow said that we would prefer proxies~ that we would buy their shares as we said we would, but that we would prefer proxies' (in camera). This again raises questions. If acceptances of the bid were actively discouraged, why was the bid made? The Committee has found that Glomex, the parent, actually sold more shares (109,000) than it bought (65,000) during the month of January 1971, while the public still had grounds for believing that the Glomex/Belinda bid was still current because of the public debate which Belinda was conducting against the Genoa directors into the second half of that month.

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From these considerations, the Committee is inclined to think that the first-come bid was not intended primarily, if at all, as a means of acquiring Genoa shares. It may rather, as one of a range of optional purposes, have been designed to facilitate the process of unloading at a profit the shares which Glomex already had; and if events worked out rather differently this would be because Glomex had indeed found that it was able to unload more shares than it had expected on the day before the bid was announced. The mounting of forces for a heavy selling wave on 31 December may have been intended to succeed in either of two ways: to bear down the price of Genoa, if its market was unsupported, preparatory to Belinda's propaganda compaign to gain proxies against the directors which was associated with the first-come offer, or else to permit a profitable sell-out by Glomex if the Genoa market did hold up. It might even have been hoped to combine the two results, judging from some of the remarks heard in evidence: an each-way bet, requiring no outlay but offering the chance of a profitable sell-out combined with a large accession of shareholders' proxies so as to give the Martin group control of the Genoa cashbox. A reading of the Belinda circular letter of 19 January, appealing for proxies and attacking the Genoa board weeks after Glomex had unloaded its Genoa shares, suggests that this may still have been the aspiration.

Whichever one of these alternative motives really lay behind the Belinda first-come bid, each of them involved deception of the market, of the public and the shareholders of Genoa as to the meaning of the first-come announcement. The history of the Belinda exercise suggests that offers for substantial parcels of shares may be exploited for purposes opposite to what the public naturally assumes is the intention. It can be associated with a selling, rather than a buying, operation by the ostensible bidder or those close to him. It is possible that other ostensible 'first come' or partial bids made on other occasions with apparently unsuccessful results, have in fact been associated with similar unloading operations. When the exercise is embellished with public misrepresentations, as in Belinda's case, there can be substantial scope for abuse.

The Significance of John T. Martin & Co.

We may now attempt an approximate estimate of the order of the losses on speculative share-trading suffered by Australian Continental Resources and Glomex Mines together. In the case of ACR, we have noted Mr Foot's estimate that the losses to be realised on these investments were about $900,000 and his further evidence that the receipt of more than $250,000 of the proceeds of the realisations was in jeopardy as a result of John T. Martin's default. When Glomex's apparent losses of $503,000 on share-trading are taken into account, it seems likely that the inherent conflict of interests between Mr Martin's roles as a broker and as director or promoter of these two public companies has been the substantial cause of losses to their unwitting shareholders amounting to more than $1,600,000.

The account which has been given in this chapter of conflicting interests deliberately fostered and turned to advantage, of misused client funds, of concealment and deception in John T. Martin & Co., leading to heavy losses for the public, is not intended to be exhaustive. Two things should be said concerning the Committee's decision to examine this firm's affairs in detail. First, until the Committee entered into that examination the public had no reason to expect, from the external evidence, that these practices existed. For instance, just after the firm was barred from further trading, the Chairman of the Melbourne Stock Exchange, Sir Cecil Looker, was reported as saying: 'You can't put the blame on to anybody in particular. It's an outworking of all the speculative fever that overtook the market last year'. He was also reported as saying that there had been several bad debts and that he felt 'great sorrow' at the firm's default (Australian, 7 April 1971). The Committee turned to the largest recently failed firm as a means of gaining evidence without unduly inconveniencing or disadvantaging those who remained in the industry. Secondly, this Senate Select Committee on Securities and Exchange was in existence, and known to be conducting its inquiries, throughout the life of John T. Martin & Co. as a broking business. All the practices which have been discussed in this chapter were carried on by members of that firm who knew of the existence of State and Stock Exchange regulations covering their operations. Presumably, they believed that the practices which have been discussed would go unremarked by this Committee, as they were undetected by the Stock Exchange of Melbourne and other authorities. This assumption was apparently based on the long experience of Mr Martin and his senior colleagues in the broking industry, and in the absence of a system of adequate spot checking by some authority the assumption was by no means unreasonable. Had it not been for this firm's mere inefficiency - managerial incompetence, weak staff control and bad speculative judgment - the nature of its business standards would doubtless have avoided exposure.

Mr Justice Street, of the Supreme Court of New South Wales, has made a similar remark in a judgment he delivered in July 1971, in a case (Bonds & Securities (Trading) Pty Ltd v Glomex Mines and Others) which involved some aspects of the affairs of this broking firm. Referring to John T. Martin & Co., His Honor said: 'Its deficiencies in observance of proper and honourable dealing as a broker might well have passed unnoticed, had it not committed the cardinal sin of running out of money'. Mr Justice Street was principally concerned to adjudicate on an issue arising out of an example of fraudulent conduct which has not been traversed in this Report, involving one Arthur Macleay, a clerk in the Sydney office of John T. Martin & Co; but His Honor's observations during the hearing of the case led him to say in the judgment: 'It is not surprising to find Macleay's fraud and the misapplication of the plaintiff's money occurring in an office where questionable standards appear to have been the order of the day'. Mr Justice Street drew a number of general conclusions from his experience relating especially to the need to eliminate the scope for conflicts of interest in broking firms and the need for improved standards of security in client trust accounts. The full text of the judgment is reproduced as Committee Document 4-3.

Several consequences arising from the broking firm's cultivation of mutually conflicting functions have formed a considerable part of the discussion in this chapter. One further consequence which should be mentioned was the misapplication of a range of personal talents and qualifications. The conflicting roles of John T. Martin & Co. in its external relationship militated against effective internal operation, and became mirrored in the development of personal conflicts inside the firm. There were two elements in the process: the functions of some individuals tended to be in conflict with the functions of others, and the general commercial tone and standards of the firm rubbed off on to the attitude of some employees of the firm as well as to the public. While the principals made use of certain employees as their proxies in the company involvements which entailed considerable disguised speculation with public company funds, some employees in turn exploited the firm by running up unpayable and concealed debts in their personal share speculation. Mr Martin has previously been quoted as saying that when he appointed Messrs Pitts and Handley as directors of Glomex, he had the idea that 'like Franco they could find opportunity where they were sent to find service'. The kind of opportunity he had in mind may have been as ambiguous as the kind of service, but the opportunity was liable to conflict with the service.

Elements of the mutual recriminations between principals and employees filtered into the evidence given to the Committee. Thus, Mr Massey intimated that he regarded the final Belinda exercise in Genoa shares as a 'very poor' way to achieve an objective, and he said of Mr Handley:

His actions on behalf of Belinda would specifically have been in his capacity as director of Glomex, or whatever he was. They were not as an employee of mine, and I was very unhappy about a lot of events during this period.

(in camera)

From the other side, Mr Handley gave expression to a climate of mounting internal antipathies in a passage of his letter to the Committee (Committee Document 4-1) when he said:

It may have been that Martin thought when he appointed me to the board [of Glomex] that he was appointing a dupe. However, I am sure that my subsequent conduct indicated to him and others that I did not regard myself as any sort of nominee.

It is only fair to say that initially I had confidence in Martin based on his being a partner in a leading stock broking firm, his obvious wealth and the substantial staff which his firm employed. Unfortunately, my faith and confidence was not justified and as time passed I became suspicious of his motives.

This suspicion arose partly from his shocking performance in investing funds entrusted to him from Glomex and his persistent urging to buy further shares based on what in my judgment was questionable logic.

I became suspicious that his only motive was to increase brokerage for the firm.

The insights which have been afforded into aspects of the securities industry by the chance failures of firms such as John T. Martin & Co. and others which we have looked into cannot easily be dismissed or explained away. The Committee recognises that care must be taken in drawing conclusions based upon a limited number of cases of firms which have failed. For instance, one cannot assert that the varieties of conflict or malpractice and disregard of clients' financial security which have been revealed in the Martin firm's affairs are rife in the broking industry. However, neither can one say that they are an isolated case. The supervisory system in operation allowed such practices to flourish in this firm at heavy loss to the public, and would do the same for other firms. The members of John T. Martin & Co. were able to write most of their own rules, the main rule apparently being that they should not be found out, and nimbleness of tongue could be taken as sufficient to promise that. The firm had reason to expect that its practices would go unquestioned, since it naturally assumed that it was going to remain solvent, and it had brought the arts of interstate dispersion and the deployment of employees as proxies to a suitable level of finesse to be able to cope with such supervisory routines as existed.

Up to the time of the preparation of this Report, no stock exchange or State government authority has shown that it has obtained an understanding of the real circumstances of this firm's failure with a view to considering whether the firm's record establishes a case for changes in the supervisory methods employed by those authorities. Yet our inquiries have shown that the existing investigatory and control procedures of the regulatory authorities failed to protect the public from the practices revealed in this chapter.

CHAPTER 5
THE DEFAULT OF MICHAEL RICKETSON & CO.

Mr Michael Ricketson had been engaged in sharebroking for sixteen years and had been a full member of the Stock Exchange of Melbourne for eleven years, as a partner in J.B. Were and Son, when he set up as a sole trader in September 1965, trading as Michael Ricketson & Co. Nearly six years later, on 18 June 1971 he was barred from membership of the Melbourne Exchange, after having been declared by the stock exchange to be in default.

This Committee took the opportunity to question Mr Ricketson on the background and causes of his failure, and subsequently we carried out further investigations. We found that this case threw light on issues relating to the general conduct and the surveillance by the stock exchanges of brokers' activities, including in particular the practice of house trading. This term is used to describe share trading by broking firms carried out for the beneficial interests of the partners themselves. Trading of this sort often takes place through what is known as a 'house account', which gives rise to the term 'house trading'. The Committee's inquiries also raised questions concerning, for example, the appropriate assets which a broking firm should hold in readiness for contingencies, the structure and form of a firm's balance sheet and accounts, and the standards which should be applied to their auditing. These matters will be briefly outlined.

House Trading

Mr Ricketson himself stated to the Committee that 'I do not consider house account trading activities to be a cause of the firm's downfall' (Ev. 1773), and his opinion may at first appear justified. It might be said that house trading had sustained him and enabled him to get his business going in the early years. It will be suggested, however, that the relationship between the firm's agency and broking roles was always more complex than this, until finally the heavy dependence on house trading greatly exacerbated other difficulties in the critical year 1970-71, when house trading itself involved losses after having yielded large profits in the previous year.

Mr Ricketson's was a class of broking business that was geared to dependence upon house trading profits at all times, and this was related, in part at least, to its rather small agency clientele. Mr Ricketson had resigned his partnership in a firm which did not permit active trading by the partners, and it appears from the financial history of his own firm that a definite departure from that policy was, from the start, part of his business strategy as a sole trader. The role that house trading played in the firm's eventual downfall will be seen below.

The results of Mr Ricketson's first nine month's operations were as follows:

1966-67	$
Income from brokerage (gross)	17,000
House trading profit (gross)	10,000
	27,000
Operational expenses	47,000
Loss	20,000

While the allocation of operating expenses as between the agency and house trading activities is not always a simple matter, there can be no doubt that the brokerage business proper was unprofitable in that establishment year, and Mr Ricketson was cushioning the losses with the profits obtained from his own buying and selling of shares.

1966-67 had been a quiet year in the market, but the following year was different. The market was given stimulus by the oil discoveries in Bass Strait and by the discovery of nickel by Western Mining Corporation at Kambalda, and this was the one year in the history of Michael Ricketson & Co. when the agency side of the business was unquestionably profitable. The agency part of its profit, however, was eclipsed by the big speculative earnings made on house trading:

1967-68	$
Income from brokerage (gross)	106,000
House trading profit (gross)	150 000
	256,000
Operational expenses	86,000
Profit	170,000

The new firm had been present at the birth of an exceptional share boom. A subsequent downturn was to be expected, but when it came in the following year, 1968-69, the firm's brokerage turnover remained at substantial levels. Nevertheless, rising office expenses and a loss on house trading (before the allocation of any part of the office expenses) in the general subsidence of share prices left the firm showing an overall loss of $73,000 shared between its two classes of activity which always tended to move in the same direction from year to year.

1968-69	$
Income from brokerage (gross)	80,000
House trading loss	59,000
	21,000
Operational expenses	94,000
Loss	73,000

Early in the next year, there came the 'Poseidon boom', but although house trading again gained from the upturn in prices in the speculative market, brokerage revenue did not show as great a rise as did office expenses:

1969-70	$
Income from brokerage (gross)	97,000
House trading profit (gross)	60,000
	157,000
Operational expenses	124,000
Profit	33,000

The large increase in the firm's operational expenses is not easily explained even after our discussions with Mr Ricketson. The number of employed staff, from three or four at the start, rose to a peak of between twelve and fourteen in the Poseidon boom, then fell back to seven or eight. Mr Ricketson pointed out that 'generous bonuses ... a prosperity expense' were paid in the good years, but the records available to the Committee do not permit quantification of this element.

The Committee does not have a reliable set of accounts for 1970-71, the next and last year of this firm's existence when share prices and turnovers fell disastrously and the staff was cut back to half. The available information indicated, however, that operational expenses remained more than twice as high as brokerage income, and much higher than expenses had been four years previously.

Summarising the four years' life of this firm, it appears that its brokerage income for the whole period, $300,000, fell far short of its total operating expenses, $351,000, even though most of the period had been distinctly buoyant for share business by any historical standards. In the meantime, the firm had come to rely on house-account trading for survival. But it appeared to the Committee that Mr Ricketson himself did not understand why the brokerage was apparently so unremunerative.

As an indication of the relative importance of the agency and the speculative sides of Mr Ricketson's business, the respective turnover figures for the period from 1 July 1970 to 10 June 1971 are available. The value of share turnover on the agency side was about $2.25 million, while the firm's house account business amounted to about $8 million. In the latter figure, over $4 million represented the firm's purchases, and $3.9 million were sales.

The definition of 'house account' types of business varies with firms, and Mr Ricketson in his evidence said that not all of this business was 'pure trading'. He commented that 'house account trading is a dirty word in a lot of people's minds, sometimes correctly and sometimes not correctly' (Ev. 1777). He suggested that in his firm's case there was 'a great deal of house account trading, as it appears in the books' that was really quite orthodox in character (Ev. 1774). In the first place, he explained that a great deal of it was simply transactions between his firm and other brokers, either interstate or in London. 'Much of the business with these people is done as one principal to another', he said, 'so the share account or house account is the convenient place through which to put the entries' (Ev. 1774). Subsequently, however, Mr Ricketson acknowledged that his statement on this point was in error. He then accepted the understanding which this Committee had formed after the inquiry, that his firm's house account had not included business done for other brokers in Victoria, interstate or overseas, but that separate records were kept in respect of that business (Ev. 1779).

Mr Ricketson's second qualification regarding the character of his house account trading was that there were many occasions when 'significant parcels of first class stock' became available on the market, and he had built up large enough holdings of them to be suitable for offering to life offices and other financial institutions (Ev. 1777). This Committee accepts the point that such business was included in his firm's returns of house trading, but Mr Ricketson has confirmed the further fact that this 'accumulation' business was not a significant part of the house trading account. Evidence to support this was provided by an examination of the list of trading stocks held by the firm on 10 June 1971, in which there was a heavy preponderance of mining stocks of a speculative character. The conclusion essentially stands that the broking firm of Michael Ricketson & Co. was a heavy and active share dealer, trading through the house account for the beneficial interest of the proprietor.

Brokers as Privileged Speculators

Reference has already been made to the argument that the profits from the house trading account of a firm such as Michael Ricketson & Co. helped to sustain the agency business when it was unprofitable. This, however, is not an adequate or satisfactory appreciation of the inter-relationship that exists between the two kinds of activity in a broking firm.

Mr Ricketson's position as a member of the stock exchange permitted him, when dealing for himself, to deal through his own firm, paying no brokerage. Any ordinary member of the public engaging in such a scale of speculative activity as Mr Ricketson's amounting to $7.9 million in the firm's last year, would have had to pay in brokerage no less than $79,500, given that all the orders had been in amounts of $50,000 or above so as to attract the minimum rates of brokerage. If all the dealings had been in amounts of $10,OOO or less, as many of Mr Ricketson's were, the maximum rate of brokerage would have applied, involving a total brokerage cost of $158,000.

Even though Mr Ricketson did not have to consider this cost of brokerage in deciding whether or not to carry out his trading, he would presumably have weighed up the potential profits from such transactions against the costs his firm would incur in carrying out the dealings. For example, running the house account involved the time of himself and staff, and he should have allocated to the dealings through this account part of the firm's other overhead charges. In the year 1970-71, since the volume of house trading was more than three times as great as the turnover of shares on agency account, it may be conjectured that a substantial part of the general office expenses at the time, as well as the costs of running the stock exchanges that could be apportioned to the business coming from that firm, were being incurred on behalf of Mr Ricketson as a private trader.

It would seem, then, that Mr Ricketson's advantage over clients in the saving of costs when playing the market cannot be measured by the full brokerage costs. However, the question arises as to whether, in setting brokerage charges at a particular level, stock exchanges require public investors who pay these charges to meet the costs that arise not only from the public's dealings, but also from the brokers' own dealings. This is one of a number of complex questions involving brokerage rates; here we note that it is likely that stockbrokers are passing on to the investing public some of the costs arising from their own trading, and that this is one of the advantages brokers have over the investing public in their role as speculators in the market.

The Collapse

It has already been said that the Committee considers the character of the firm's business to be highly relevant to an understanding of its eventual collapse, though Mr Ricketson seemed not to share that view. Before proceeding to make other observations arising from our examination, it is valuable to note the causes which Mr Ricketson himself advances for his failure. Mr Ricketson had no doubt as to what was the greatest cause:

You could quite simply date the true watershed in the running down of the business from the day Minsec crashed. We had no direct interest or no direct bad result from Minsec. We were not involved with that and our clients were not involved with that. I am now talking market activity. It just chopped off as one would chop it off with an axe.

(Ev. 1762)

On further examination, Mr Ricketson acknowledged several other factors in the failure. First and foremost was the scale of unrecoverable debts owed by his clients. If one were looking for 'a single common factor' behind these bad debts themselves, it would be that many clients had over-extended themselves by placing orders for shares without having the money to pay for them. The more the market declined, the less these people were able to obtain by realising on their other share-holdings and the less could Mr Ricketson himself hope to recover when he would 'sell clients either wholly out or partially out' (Ev. 1768). When questioned about his willingness to execute orders for such clients, most of whom were necessarily fairly new in his firm's case, Mr Ricketson paid noteworthy deference to the climate of urgency to buy among those engaged in the share market during the conditions of a hectic boom:

You must appreciate that in busy times time is not on your side. It is running against you. This is not just a lust for making money and wanting to grab every client. It is just the way the stockbroking world works at times.

(Ev. 1785)

Mr Ricketson appeared to feel he was describing the experience of other brokers besides himself. It is the general instinct of the market on such occasions. It is perhaps the way lemmings would explain themselves if ~hey could speak as they swim on to the end in the ocean.

Next, Mr Ricketson pointed to the effects of a diminished cash flow and falling security prices after the Minsec crisis upon the attitudes of his bankers, a matter discussed in a separate section below. Another factor was the collapse of his firm's Adelaide agents, A.J. Green, Burchell & Co., members of the Adelaide Stock Exchange, in March 1971 followed by the effects, 'more psychological than actual' of the failure of two Melbourne broking firms. Finally, he mentioned the fact that 'after Minsec, London also just chopped off'. He had been depending on a continuing demand from London brokers to sustain his cash flow, but now~ as he said, 'to coin their own phrase, they "had had Australia for the time being"'.

It may be deduced that Mr Ricketson continued to see the causes of his insolvency as being all proximate ones and all related to the market's failure to maintain the impetus of the Poseidon boom. The underlying questions remain as to why the firm was incapable of surviving the change in market climate, and why there was no adequate checking system, whether from the stock exchange or the Registrar of Companies, to ensure that the firm's procedures and its assets structure were in more reasonable shape to meet variable conditions.

When the final collapse came, the firm's financial deficiency (estimated at about $329,000 on 8 December 1971 by the Receiver/Manager) turned out to be very large in comparison with the funds totalling $62,090 which had been the amount invested in the business by Mr Ricketson at 50 June 1970. In this Committee's view, the deficiency had been accumulating for more than just a few months before the default, so that a further question which arises is why the stock exchange regulatory procedures failed to bring this firm's problems to light at a much earlier stage.

Structure of the Balance Sheet

The balance sheet of Mr Ricketson's firm was not unusual in having on the assets' side to meet its liabilities a large portfolio of listed shares, including some of a volatile market character. It is of the nature of such assets that they are of least practical usefulness just when they are most needed. Mr Ricketson agreed with the suggestion put to him by the Committee that:

At a time when, in the conduct of a broker's business, it is most likely that he may be involved in calling upon his liquid capital funds to support the business, if those funds are represented by shares then it is likely that those shares will have a depressed value at the time he needs to call on them.

(Ev. 1783)

But no less remarkable is the heavy investment that Mr Ricketson's broking firm had come to make in real estate properties, mainly in seven houses, as a form of security for the needs of such a business. At June 1971, the firm's holding of properties was in the books at $171,252, and was easily the most important asset remaining to it. He had increased his holdings of real estate by no less than $110,252 in the year 1969-70, in the belief that they were a hedge against the vagaries of the share market. They were an illiquid asset in his crisis, and for practical purposes no use to the broking business which owned them except as security for bank borrowing.

Another illiquid asset in the balance sheet which was of no practical use to the broking business was a painting. This was shown in the books in June 1971 at $16,000, having been written up in value by $8,000 above its cost.

The unqueried movements in the firm's balance sheets - unqueried, that is, by the stock exchange - also included a writing up of the book value of Mr Ricketson's seat on the Melbourne Stock Exchange in stages from the cost price of $10,000 to a figure of $30,000 in the two years ended June 1970o Apart from the fact that the latter figure exceeded the realisable value of the seat at the time of the emergency (the seat was subsequently sold for $23,500), this Committee was concerned that member firms of the stock exchange could write up an intangible asset of this kind in order to boost the figure claimed for proprietor's funds and so, on the face of the balance sheet, strengthen the financial position of the firm without having to satisfy any inquiries from the stock exchange. Several other instances of this practice came to the attention of the Committee in its examination of brokers' accounts and, in one case, the broking firm would have had a deficiency in its capital account had it not been for the writing up of the seat held in this way. The Committee has also noted that the practice of including a seat on a stock exchange in a broker's capital account for the purpose of determining his financial stability is of doubtful value to creditors owing to the existence of the rule that upon failure a broker's seat is forfeited to the exchange or at least subject to sale by the exchange in the manner described in Chapter 6.

Action by the Stock Exchange

Though Mr Ricketson was unwise in holding so much of his firm's funds in speculative shares, houses and a painting, especially in view of the speculative nature of his business, he was not breaking any stock exchange rule or regulation, or even failing to meet any stock exchange guideline, in constructing his balance sheet in this way. Part of the explanation for the Melbourne Stock Exchange's failure to be informed of these various matters involving the nature of the business conducted by

Michael Ricketson & Co. was touched on by Mr Ricketson himself in a different context when describing his difficulties (amounting to a sense of impossibility) in approaching the stock exchange or its chairman for counsel and help before his problems became quite insuperable. Mr Ricketson drew attention to an article (number 60) of the articles of the Melbourne Stock Exchange which he thought was 'very tough' in that it did not make provision for the temporary suspension of a member while he overcame his financial problems. In the words of Mr Ricketson, article 60 'means that you are alive or dead; there is no shade of grey' (Ev. 1766-67). The precise wording of the article concerned is as follows:

A member who in the opinion of the committee has failed or is unable to fulfil his engagements upon the stock exchange shall be a defaulter on the stock exchange, and any such member, and any member who is proved to the satisfaction of the committee to be insolvent (although he may not be a defaulter on the stock exchange), shall, upon the committee so resolving, be posted on the stock exchange by the chairman or member of committee acting as chairman declaring him to be a defaulter and thereupon he shall cease to be a member ...

It seems to the Committee that this article (since modified by the passing of a new article) was not as severe as Mr Ricketson suggested, in that it did not preclude his seeking advice from the exchange in overcoming problems in running his business before it reached the point of insolvency. Even so, some of Mr Ricketson's remarks have a general bearing on the difficulty inherent in a system where the supervision of a broker's internal affairs is left mainly to those who are his competitors and with whom he is also doing daily business which involves the giving and taking of credit for varying periods of time. Mr Ricketson explained to the Committee:

... it is an extremely delicate thing even to talk off the record to one of your fellow members and to seek his advice or help in certain situations. You are imposing a great load on him both from his own business point of view and from his approach to his fellow members as a whole. As far as the chairman is concerned, it is again virtually impossible to talk to the chairman of the Stock Exchange of Melbourne on an off the record basis. He just cannot do this.

(Ev. 1766-67)

The circumstances in which Mr Ricketson did come to be interviewed by the chairman of the Melbourne Stock Exchange arose in the following way. About the middle of the week ending Friday, 11 June 1971, Mr Ricketson telephoned Mr L. Muir, a partner in Ian Potter & Co. with whom he was friendly, and informed him that he was having problems with his firm and that he would like to discuss these in the office of Michael Ricketson & Co. The discussion took place on Wednesday, 9 June, and in the course of this Mr Ricketson said that he was concerned about the survival of his firm and that he hoped Ian Potter & Co. would provide assistance or take over his business. Shortly after the meeting Mr Muir telephoned Mr Ricketson to say that he had discussed the matter with his partners, among whom, as senior partner, was Sir Cecil Looker, who was also, at the time, chairman of the Melbourne Stock Exchange. Mr Muir told Mr Ricketson that Ian Potter & Co. would not be able to take over Michael Ricketson & Co. and he also suggested that Mr Ricketson should discuss his difficulties with the chairman of the Melbourne Stock Exchange. On 10 June the firm of Ian Potter & Co. lent Michael Ricketson & Co. $16,500 in order to keep the firm's overdraft within the limit set by one of the firm's banks.

After learning of Mr Ricketson’s problems from Mr Muir, Sir Cecil Looker telephoned Mr Ricketson and asked him to come to his chairman's office at the Melbourne Exchange on the morning of Friday, 11 June. Sir Cecil Looker informed us that after this interview he immediately instructed the stock exchange accountants 'to carry out an immediate investigation' (Committee Document 5-1). The accountants themselves noted that their instructions were 'to review the financial statements of the subject member firm who was suffering from liquidity problems' (Committee Document 5-1, see notes attached). In order to begin this examination they contacted Mr Ricketson's auditor who, between Friday, 11 June and Tuesday, 15 June, prepared a balance sheet as at 11 June 1971, and a profit and loss account for the year to 11 June 1971. The same day as the chairman of the Melbourne Exchange interviewed Mr Ricketson (11 June) his own firm, Ian Potter & Co., lent Michael Ricketson & Co. a further $8,500. It was soon to be known that Mr Ricketson's firm needed a far larger injection of capital if it were to recover, but at the time there was no monitoring procedure in operation that could have provided the information necessary to assess the firm's predicament. In our view it is also doubtful if Mr Ricketson himself was fully aware of his firm's perilous financial state.

When the auditor had finished the preparation of the accounts of Mr Ricketson's business, it was known that the firm had made a large loss of $155,000 in the year to date. However, owing to the introduction of a large amount of new capital into the business during the year, proprietor's funds were still $40,761 - an amount that could well have been judged sufficient for the running of a modest business so long as current losses were immediately stopped. At about this time the chairman of the Melbourne Exchange was also hoping Mr Ricketson would obtain funds from the sale of some personal assets he and his wife held (Committee Document 5-1). But as was to be fully revealed shortly after the firm's collapse, these accounts of Michael Ricketson & Co. prepared by the auditor during the weekend and passed on to the chairman on 15 June were grossly inaccurate, giving unrealistically low figures for the trading losses during the year and unrealistically high figures for the proprietor's funds invested in the business. Moreover, no information was given in the accounts themselves on the state of the trust account, or on the improper use being made of clients' scrip (see next section). However, the stock exchange accountants were aware of at least some of these shortcomings in the auditor's accounts, for in their own notes they increased the provision for bad debts to such an extent that there was a substantial deficiency in the firm's capital account (proprietor's funds). The stock exchange accountants were also aware at the time of some of the irregularities in the trust account and in the use of clients' scrip, and they informed the chairman of the Melbourne Stock Exchange of these matters between 15 and 17 June 1971 (Committee Document 5-2).

These deficiencies and irregularities did not, however, lead immediately to Mr Ricketson ceasing trading, and his firm continued to do business up to and including Thursday, 17 June. Mr Ricketson said that during this week there was no house trading, apart from 'line-switching' (see below). It was the continuing decline in the value of the shares held by the firm's banks as security for overdrafts, the failure to recover debts owing by clients, and the pressing demands for payments by creditors, that led to the now inevitable failure. On the morning of 18 June, Mr Ricketson was formally notified of his default. This decision was made by the committee of the Melbourne Stock Exchange which was told that morning for the first time of the state of Mr Ricketson's firm's affairs. During this final week, Ian Potter & Co. guaranteed Mr Ricketson’s firm's overdraft at one of the banks to the extent of $6,000, and after the firm's failure this sum was paid to the bank, bringing the total amount provided by Ian Potter & Co. to assist Mr Ricketson to $32,000. Subsequently the stock exchange reimbursed Ian Potter & Co. the full amount that was deemed to have been paid on behalf of the exchange to try to prevent the firm's default.

In a letter to this Committee on 25 July 1972 explaining some of the steps he took as chairman of the Melbourne Stock Exchange to guard against the financial failure of Michael Ricketson & Co., Sir Cecil Looker gave an insight into the informal and somewhat paternalistic way in which self-regulation by the stock exchange proceeds. He said that at about the time of Mr Ricketson's default, rumours about the insolvency of member firms 'were rife', but that the name of Michael Ricketson & Co. was never mentioned to him as one of the firms that could be in trouble. However, in a confidential discussion with a banker during May 1971, Sir Cecil Looker 'learnt that Mr Ricketson had a tight liquidity position but that the matter had been put in order by the introduction of additional funds'. Following this conversation, the chairman of the exchange telephoned Mr Ricketson and 'instructed him that if he ever had financial problems he was to contact [him] immediately'. Sir Cecil Looker informed the Committee that Mr Ricketson 'undertook to do this but, unfortunately, this undertaking was not honoured ... the first I knew of his problems was when he made an approach to one of my partners' (Committee Document 5-1).

Broker Irregularities

Upon the appointment of a Receiver/Manager on 18 June 1971, it was quickly revealed that large numbers of shares which had been purchased for clients of the broking firm, some of whom had paid in full for this scrip, were being held by two trading banks as security for loans made to Michael Ricketson & Co. Most of the clients had not given permission for their scrip to be used in this way, and in numerous instances the clients had paid for their shares over six months before the time of the default. In some cases clients had paid for their shares over a year before the collapse. Among the certificates and transfers that were being used in this way were some which were in the name of M.S. Ricketson and some which were in the name of the firm's nominee company. Mr Ricketson's explanation to the Committee of these matters in a letter dated 19 July 1971 (Committee Document 5-4) was that he did not at the time regard them as 'either improper or particularly unusual, and at no time did it occur to [him] that there would not be ample money from debtors and other sources to cover all liabilities of this nature'.

When considering the role of trading banks in extending overdrafts to Michael Ricketson & Co., the question arose about the extent to which banks, through their provision of relatively easy credit to brokers, have aggravated speculative share markets, both on the upswing and the downswing. In Mr Ricketson's case they seem to have been indulgent in granting credit. Excluding the trust accounts, the firm ran accounts at three trading banks and each of these accounts was overdrawn at the time of the default. The total of the overdrafts was about $344,000, a level which had been substantially exceeded during the previous three years. Two of the overdrafts totalling about $239,000 were secured by freehold properties with a book value of about $156,000. The remaining overdraft of about $105,000 was secured by scrip, mainly of mineral exploration companies. Shares of such companies are notoriously speculative; nevertheless, the bank was surprisingly liberal in its extension of credit, for the arrangement was that it would provide an overdraft of up to 85 to 90 per cent of the value of this scrip.

As we have already said, as of 30 June 1970, the proprietor's funds in the broking business were about $62,000, including the claimed value of the seat on the exchange ($30,000). Compared with the firm's capital then, the overdrafts of about $344,000 were remarkably large, and it might be wondered how a broker conducting what was mainly a speculative share-trading business was able to command such extensive credit facilities.

While share prices were rising this ready availability of credit greatly assisted the firm's house trading, and allowed it to earn high profits in relation to the proprietor's funds invested. But as Mr Ricketson himself implied, the willingness of a bank to grant credit on such attractive terms turned out to be a 'two-edged sword', for once share prices turned down,there was a daily problem in keeping the bank from foreclosing on its security.

... The bank kept a daily watch on the value of those shares and there was a margin. A 10 or 15 per cent market margin had to be maintained in that sense ... The bank was watching that angle every day, and you can imagine that in the falling market from February through till June that was a difficult situation to live with - right out of your own control in the sense of good stock going down and not a thing you could do about it.

(Ev. 1782)

The thinness of the margin by which the market value of the scrip held as collateral had to exceed the amount of the overdraft encouraged Mr Ricketson to undertake a high degree of sharepurchasing in relation to his firm's capital. This added to the element of speculative dealing in the market. On the other hand, the same small margin meant that share prices did not have to fall far before much of the firm's capital was lost. To remain solvent, Mr Ricketson had either to sell shares quickly at the first sign of a downturn - thereby adding to the existing selling pressures in the market - and reduce both his share holdings and his overdrafts, or to build up profits from his agency business, which is a long-term process. He was successful with neither policy.

The Committee must also record the fact that it has received evidence that there was a deficiency in the firm's trust account on 18 June 1971 of several hundred thousand dollars. Although Mr Ricketson disputed the procedure which had been used in calculating the sum that should have been in this trust account, it is clear that this aspect of the business had been inadequately managed for some considerable time, without the matter being discovered by the regulatory authorities. Moreover, we are also of the view that, given only average skill on the part of the investigator in understanding a broker's accounts, a short, inexpensive check would have quickly revealed the weaknesses in the management of Mr Ricketson's trust accounts months before the final collapse.

One further aspect of the firm's business which the stock exchange failed to take adequate steps to regulate, was the use made of the firm's house-account in dealings with clients. We have already pointed out that it is through the house-account that many brokers carry out dealings for their own beneficial interests. Thus when a broking firm buys shares from a client for the house-account, or sells shares to a client from the house-account, the broker is acting as a principal, and should disclose this fact to the client under stock exchange regulations. In addition, in such dealings the client should not be charged brokerage, as the broking firm is not acting as an agent in the transactions. We made a random check of several transactions between the house-account of Michael Ricketson & Co. and clients during 1970-71, and found that in each case the client was charged brokerage. In our view any moderately competent investigator would have readily discovered this information. In fact, no one from the stock exchange ever inquired. The auditor's terms of reference did n~ require him to check this aspect of the firm's behaviour.

Mr Ricketson's explanation in answer to our inquiry into these transactions in which brokerage was charged was that his firm seldom dealt as principals with clients but that when it did, the client was issued with a contract note to show that the firm was acting as a principal. Mr Ricketson also said: 'The practice of expressing on a principal's contract note a price described as a market price plus usual brokerage charge etc. was a common one, going back many years in the industry'. (Committee Document 5-4). The Committee then wrote to three of the firm's clients to whom Michael Ricketson & Co. had sold shares as a principal, but in only one instance were we successful in recovering the original contract note. In this case brokerage was charged and there was no indication on the contract note that the stockbroker had been acting as a principal.

Line-switching

Michael Ricketson & Co. made extensive use of a practice known as 'line-switching' in order to try to improve the short-term liquid position of his firm. This same practice also assisted the firm in engaging in a level of house-account trading that was high relative to proprietor's funds. In the Committee's view this practice was inadequately regulated in Mr Ricketson's firm, leading to the firm in effect using client's funds for its own trading. In Mr Ricketson's words (letter to the Committee of 19 July 1972, Committee Document 5-4); 'I was never questioned by the Stock Exchange or by my firm's auditors about the way in which my firm made use of line-switching'.

To explain the technique of 'line-switching' it is necessary to go into some detail. One lot of, say, a hundred shares in B.H.P. is the same as any other lot of a hundred shares in that company. This indistinguishability of listed shares in a company means that a broker need not deliver to a client the same parcel of a hundred shares which the client actually bought in B.H.P. at the time the broker carried out the purchase, but may provide another lot of a hundred B.H.P. shares obtained from a different transaction. In the same way, where scrip is received by a broker from a vendor, the broker need not necessarily deliver that scrip to the purchaser who was recorded as having bought that particular parcel. This process of allocating shares not to the buyer who originally bought them, but to some other buyer, is known as 'line-switching'. Another term which is sometimes used is 'contract switching', and we have also come across the term 'hotch-potch' being used in connection with this practice. Although line-switching has legimitate uses, the practice can be abused when, for example, brokers use it in order to facilitate house trading without having to provide the capital for these dealings. In short, by means of line-switching brokers can trade on their own account, improperly using their clients' funds for their own speculative dealings. The following simplified example will make this clear.

If broker A buys for a client 100 B.H.P. shares at $10 each in the market from Broker B, and the client pays the purchase price to broker A, this amount must be retained in a bank t rust account until broker A has the scrip to deliver to the client. When broker B delivers the scrip to broker A, broker A pays broker B and recovers this amount from the trust account upon delivery of the scrip to his client.

At the same time as broker A carries out the purchase described above, he may also buy for his own account 100 B.H.P. shares at $10 from broker C - or for that matter from broker B. If he does this he should pay for the cost of the shares with funds from his own resources when broker C delivers the shares. However, broker A can avoid having to find the capital funds for this purchase if he allocates these 100 B.H.P. shares delivered by broker C not to himself but to a client who has also bought 100 B.H.P. shares and who has paid for these shares and whose money is lying dormant in the trust account. In other words, taking the example already given, if broker C delivers 100 B.H.P. shares to broker A before broker B delivers 100 shares, broker A can switch the 100 shares from broker C to his client and so remove the client's funds from the trust account to his own general account. This same process can in practice be repeated many times, so that when broker B in the example delivers 100 B.H.P. shares, these, too, are allocated to a client rather than to broker A himself. This indirect use of clients' funds to finance a broker's own trading can continue so long as share turnover is high in the shares concerned, and so long as there are delays in the deliveries from the selling brokers.

Another way in which line-switching can be used by a broker in order to improve the liquid position of his firm is as follows. The broker through his house account sells, say, 100 B.H.P. shares at $10 and at about the same time buys 100 B.H.P. shares at $10. Immediately after the sale he delivers 100 B.H.P. shares which he has been holding in the firm for some client, probably one who is slow in paying for the shares, to the buying broker. The short-term effect of this line-switching is to obtain additional funds. But, of course, as soon as the seller of the 100 B.H.P. shares at $10 delivers them to the broker, the funds must be found to pay for these shares. If at this stage the broker defaults, the records will show that 100 B.H.P. shares which should have been held in the office for one particular client have in fact been used to complete another transaction. In Mr Ricketson’s firm there were many examples of line-switching being used in this way in an attempt to improve the firm's short-term liquid position.

Summary: The Failure of Regulation

The foregoing analysis has revealed that the business of a member of the Melbourne Stock Exchange over a period of five years was largely that of house trading. Measured by the value of share turnover in 1970-71, house trading at about $8 million was much larger Than the clients' business of $2.25 million. In the Committee's view, the conflicting interests faced by Mr Ricketson made it extremely difficult for him to advise clients on their investments, and to act for them with the degree of objectivity that is desirable among stockbrokers.

Most clients looking to the firm for advice would not have known that, at the same time as the firm was acting for them as agents, it was also dealing actively in the market on its own account. According to Mr Ricketson, some of the firm's clients were also share traders and, in view of the scale of Mr Ricketson’s own dealings, it seems that they in particular must at times have been trading in the markets in the same shares as the broker who was carrying out their orders. In these circumstances the broker, when perceiving a favourable buying or selling opportunity, would have had to decide whether he, personally, would take advantage of the opportunity, or instead make it available to a client. This strain on a broker's impartiality would tend to be especially heavy when the broker was under financial pressure such as that faced by Mr Ricketson. Moreover, with his private trading Mr Ricketson would have had to take into account a cost of dealing which was probably less than a client would have had to pay in brokerage. This would have meant that generally the client would have wanted to sell a share at a higher price than the broker (who had bought the share at the same price) in order to allow for his higher costs. As a result, the broker would have had the opportunity of disposing of his own shares before his client's shares, and perhaps reducing the chances of the client's selling.

The Melbourne Stock Exchange never conducted a special inquiry into the nature of the activities undertaken by Michael Ricketson & Co. and the firm's ability to finance a speculative share-trading business. Not until the time of the firm's default was the extent of the firm's house trading revealed. In addition, it was apparently only when the firm was about to default that the Melbourne Stock Exchange learned of the extent to which the firm's funds were held in illiquid house properties, a painting and speculative mineral shares. These proved to be unsuitable assets to hold as reserves to meet the liquidity crisis - a crisis to which the firm was particularly prone on account of its speculative share trading financed mainly by day-to-day overdrafts on thin margins.

Mr Ricketson himself was aware of his lack of training in accounting matters: 'In retrospect this would be the major gap in my training in sharebroking life' (Ev. 1761), and he told the Committee that he relied heavily on advice in these matters. After 1967 he did not have anyone formally as an accountant on his staff, but he had appointed auditors, who were approved by the stock exchange, and who, according to Mr Ricketson

... made a point of coming into our office at least every month - not always on the same day or anything. They would just appear and they would check the continuous record of scrip and the general things they should have been checking, I presume. They were constantly with us right from the start right to the end.

(Ev. 1763)

These auditors failed to bring to the attention of the Melbourne Stock Exchange the speculative basis on which Mr Ricketson's business rested, the way 'line-switching' was used to facilitate house trading, the illiquid nature of many of his assets, the use of clients' scrip for the purposes of obtaining bank overdrafts, the deficiencies in the running of the trust account, and the liquidity crisis facing the firm. Under the terms of their appointment, the auditors were required to report once a year to the chairman of the Melbourne Stock Exchange on the broking firm's annual balance sheet and accounts and other records. The report for the year to 50 June 1970 was received by the Melbourne Stock Exchange on 29 September 1970, but it gave no warning of any of those matters just mentioned, and it specifically reported that

The movements in proprietor's funds during the year under review were not such as to adversely affect the financial position of the Firm, and the only other matters or circumstances adversely affecting the Firm's financial position to any material extent in my/our opinion are - NIL.

The auditor also answered 'Yes' to the following question:

Whether in your opinion, the financial position of the broker during the year under review was such as to enable him to conduct his business on sound business lines, having regard to the nature and volume of business ordinarily transacted by him?

It can be seen now that the nature of Mr Ricketson's business and the way his funds were invested called for a 'No' rather than a 'Yes' in answer to the last question. But it should be said, too, that the auditor had no guidelines at all from the stock exchange on what was a 'sound' way of conducting a broking business, what was a desirable way for a firm to hold the funds invested, and what was an appropriate combination of proprietorship capital and borrowed funds given the different types of business run by member firms.

At the time of writing this Report, there are many innocent clients of Michael Ricketson & Co. who believe that they will lose outright substantial sums of money. They have already had to endure a long and uncertain wait for settlement, or part settlement, in a period when money has been losing value under pressures of inflation. But the self-regulatory processes available to check such developments would in themselves have allowed this broking firm to go further into default and deeper insolvency. As we have illustrated, it was not the stock exchange or the standard auditing procedures that brought the firm's unsound practices to a halt. The check came only from the refusal of its principal creditor, the bank, to extend accommodation. But for this, the final deficiencies and losses of clients could have been more severe.

In this Committee's view, the analysis of the affairs of Michael Ricketson & Co. shows that the regulatory authorities, over a period of five years, failed to take adequate steps to keep themselves informed of important aspects of a stockbroker's affairs regarding his dealings with the public and his financial stability. In the case of the firm's house trading, they failed to take the elementary step of finding out how much trading was taking place. They also failed to check on how line-switching was being used to assist house trading, and whether clients of the firm were being improperly charged brokerage on dealings in which the broker was acting as a principal. Not until the final few days in the life of the firm did the chairman of the Melbourne Stock Exchange obtain the firm's balance sheet and profit and loss account; up to that stage the stock exchange was content to rely upon the auditor's reports which, as we have seen, were subject to substantial weaknesses. Finally, when the financial accounts were specially prepared for the chairman of the Melbourne Exchange just before the firm's collapse, these proved to be inaccurate in important respects bearing on the firm's net worth and on the manner in which the business was being run.

CHAPTER 6
THE FAILURE OF AN ADELAIDE BROKER-UNDERWRITER

Among the members of various stock exchanges who underwrote the public share issues of companies during the period of the Committee's inquiries were a large number of brokers who had previously been inexperienced in the activities of the new issue market. One of the reasons for our investigation into the events which brought about the default of the firm A.J. Green, Burchell & Co., a member firm of the Adelaide Stock Exchange, was a wish to obtain an insight into the operations of a relatively small broking firm which had found that it could expand its business during the market conditions of 1970 to include the underwriting of capital issues of substantial size. This firm's experience was of significance for other reasons which deserve to be recorded. For a firm of such moderate size, the scale of its estimated deficiency is high, being probably more than $460,000. Further, the Committee was disturbed to find a continuing neglect of the prescribed procedures for maintaining clients' funds in a trust account. Finally, Green, Burchell's history gave the Committee an instructive view of some aspects of the general standards of self-regulation existing in the Stock Exchange of Adelaide.

A.J. Green, Burchell & Co. had defaulted in circumstances connected with the abortive arrangements for the flotation of a mineral exploration company, Panamin N.L. The following discussion is based upon the Committee's direct inquiries, the testimony of Mr Ian Philip Holroyd Wilcocks and Mr Howard William Fox, who were promoters and directors of Panamin N.L., and the transcript of proceedings before the Registrar-in-Bankruptcy, Adelaide, on the examination in May and June 1971 of Mr Allan John Green and Mr Graham Robert

Burchell, the partners of A.J. Green, Burchell & Co. In addition, in May 1973 we received letters from Mr Green and Mr Burchell in answer to our inquiries and these are included as Committee Documents 6-1 and 6-2.

The Pre-underwriting Phase

The stockbroking partnership of A.J. Green, Burchell & Co. was established in August 1970, following the Adelaide Exchange's acceptance of Mr Burchell as a member. Before this event, however, Messrs Green and Burchell had had a long experience in stockbroking in Adelaide. Mr Green acquired his seat on that Exchange in 1960, and was continuously in business as a broker with various partners, and for a period as a sole-trader, before Mr Burchell joined him first as a member of the staff in December 1969 and later (August 1970) as a partner. Mr Burchell had worked in stockbroking between the years 1948 and 1955. For a substantial part of the time following his joining the exchange, Mr Green found it difficult to establish and maintain a viable business without recurring financial problems. After benefiting from the share boom in 1968, however, Mr Green thought that the long period of marginal profitability had come to an end, and that his firm was established for the first time on a sound basis for future activity. Grounds for this optimism were to be seen in the firm's accounts. Whereas in 1967 the firm's net profit was 47,688, in 1968 it leapt to $41,027. With the benefit of these profits Mr Green was able to convert the debit balance of $11,797 in his current account with the firm into a credit of $5,905. Before the Registrar-in-Bankruptcy, Mr Green made a passing reference to his earlier, difficult years when he said the change in the current account 'was probably to wipe off the old six years of business and losses of income'.

However Mr Green's problems were not over, though it was several years before his difficulties returned in such a severe from that they led to the default of the firm. In the year to June 1969, the firm's brokerage income declined to $86,000 from $93,000 the previous year. Profits fell more than proportionately to $10,054, owing to the large increase in expenses, particularly salaries and wages. Some of Mr Green's worries began to reappear at this stage, but there then followed the Poseidon boom in which the volume of business picked up sharply, and it was through the retention of some of the apparent 'profits' from the boom that the capital account in the firm rose from $34,503 in June 1969 to $83,119 in May 1970. Not until about two years had gone by, and the affairs of the partnership had passed into the hands of the Official Receiver, was it discovered that the firm's accounts for this period were misleading, mainly owing to their failure to disclose substantial liabilities to clients. However, as far as the proprietor was concerned, his firm's 1970 accounts (which had been prepared by accountants) presented the records of a business that had had a marked turn round in its fortunes. In answering questions before the Registrar-in-Bankruptcy, Mr Green was often unclear about his firm's activities during the period of the share boom; it appeared, however, that he had found it increasingly difficult first to understand and then to cope with the day-to-day problems of running his expanding broking business. When referring specifically to the large increases in salaries (including bonuses of up to 50 per cent) he had granted to his staff, who had numbered thirty-two at one stage, he said: 'I think they were a bit too demanding ... and I was probably frightened; there was so much work and confusion going on.' Mr Green said that he had spent most of his time in advising clients, and he recalled having had '30 and 40 people in the lunch hour waiting to see him'. He said that he had found that 'with the pressure and worries' the business 'was getting out of hand'; one of his office managers was 'too demanding', but it had taken him 'six months to pluck up courage and sack him'.

Mr Green's extreme dependence on his staff for the running of his business became clear when he explained that he had known little about, and had not been able to check upon, the office and accounting procedures for handling either the clients' or the firm's transactions. When asked if he could 'interpret... the trading and profit and loss account and the balance sheet when it was prepared each year', he said 'No'. That a stockbroker could not understand the fundamental accounts of his own firm may seem surprising; and it may also be wondered how it would have been possible for him to advise investors with a desirable degree of competence when the giving of such advice would seem to be largely dependent upon an understanding of the accounts of listed companies. However, Mr Green regarded himself as a sound and cautious investment adviser who had been successful in guiding those of his firm's clients he was able to see personally past the pitfalls of the share boom (Committee Document 6-1). It must also be said that the stock exchange did not require Mr Green or any other member, or their investment advisers, to understand elementary accounting and financial records, and in this respect the Adelaide Exchange's practices were no different from those of the other exchanges. At the time of writing it is still the position that, while some courses on the securities markets are available, any partner or employee of a broking firm, regardless of the gaps in his basic training and qualifications, is free to advise members of the public on their investments.

Mr Green's reluctance and inability to manage or supervise key aspects of his own firm's affairs meant that effective control - though not responsibility, as we shall see -rested mainly with various members of the staff, several of whom had had little experience of the market except in highly speculative conditions. This relationship between Mr Green and his employees was implicitly recognised in his readiness to consent to their demands for large bonuses, and in his allowing individual members of the staff to participate in the firm's profits. In addition, he sanctioned the introduction of a scheme whereby the entire staff obtained 60 per cent of the firm's profits from what was called the 'arbitrage account', but which was in practice largely a share-trading account run by the firm's operator - the name given to the employee who conducted both the firm's and the clients' buying and selling orders. As the operator was not effectively supervised, this profit-sharing scheme meant that the employees had wide scope for speculation with the firm's capital. They stood to gain from the profits, but they did not share the losses. They also had the advantage of participating in share dealings on which no brokerage charges were paid. Our inquiries showed that, in relation to the size of the firm, the volume of share-trading which passed through the so-called 'arbitrage account' was very large, and that substantial amounts were transferred at regular intervals from this account to 'salaries and wages'. For example, the figures for monthly trading (purchases and sales) in the 'arbitrage account' during the period July to December 1970 were as follows: July, $485,827; August, $125,876; September, $446,199; October, $499,619; November, $61,827; and December, $168,216. The transfers of profits from the 'arbitrage account' to the salaries account of employees during the period December 1969 to June 1970 totalled $18,759o One particular employee had a special employment contract not directly related to the 'arbitrage account' which provided for his sharing in the firm's profits, and on 50 June 1970 a sum of $25,000 was transferred to the benefit of his loan account. (Committee Document 6-5).

In other ways, too, members of the staff were permitted to play the market: many of them had share-trading accounts, and they were able to rely on the firm for credit in conducting these activities. A member of the staff also managed one of the several share-trading companies in which Mr Green had a substantial interest. Although the firm's operator who ran the 'arbitrage account' was not permitted to trade himself -that is, on his own personal account - he traded for accounts that were opened in the names of his family and friends. Several of these people subsequently denied having authorised the share dealings carried out in their names, and the amounts owing became bad debts.

In summary, although the financial resources of Mr Green's firm appeared to be adequate in mid-1970 for running a modest broking business on sound lines, in practice the firm's operations were being conducted in a highly hazardous manner. In addition, proprietor's funds were probably substantially less than the amount shogun in the audited accounts. About this time, without having to answer any inquiries by the Adelaide Stock Exchange as to whether he had the necessary skills and financial resources to undertake new capital raising (Committee Document 6-4). Mr Green turned his attention to the underwriting of public company flotations.

The Firm as an Underwriter

The first new issue underwritten by Mr Green's firm was a $950,000 public flotation of an Adelaide mineral exploration company, Centamin N.L. The underwriting agreement was signed on 25 June 1970, and the issue took place in August 1970. From the underwriter's point of view it was a success, providing the firm with about $22,950 as an underwriting fee. After the payment of commission to other brokers who sent in applications to the issue, Mr Green's firm was left with about $18,000, a sum which included the fees to be paid to the partners' two share-trading companies which acted as sub-underwriters of the issue. Seven months later, when the broking firm had collapsed, it was found that the two share-trading and sub-underwriting companies were organisations of little substance and the Official Receiver advised us that at 1 September 1970 the companies had 'no significant surplus' (Committee Document 6-5). We are of the view that had there been any significant shortfall in the public subscriptions to the Centamin issue, the two sub-underwriting companies could not have taken up their commitments from their own resources.

The next capital raising which Mr Green's firm (now A.J. Green, Burchell & Co.) agreed to underwrite was the public flotation of Panamin No Liability, a company incorporated on 29 September 1970 for the purpose of conducting exploration. In the underwriting agreement signed on 25 November 1970 (and amended by a supplementary agreement dated 50 November 1970), the brokers undertook to lodge applications for the whole issue within 21 days of the prospectus being issued. The agreement also provided that the company would issue the prospectus on or before 2 April 1971 'or such further time as may be mutually agreed'. As the amount payable on application for the shares together with the prepayment of a first call was 20 cents a share, and there were 2.5 million shares offered, the total sum underwritten was $500,000. Although it was not mentioned in the contracts, it was understood that the promoters, directors and their associates would be subscribing for about one quarter of the issue, amounting to a sum of $125,000, leaving the broking firm with the responsibility for providing subscriptions totalling $575,000.

Mr Fox, a promoter and director of Panamin, told the Committee that the firm of Green and Burchell had been selected to underwrite the public issue because it had just completed successfully the public flotation of Centamin, which was also a mineral exploration company with tenements near where Panamin's were held in South Australia. The directors of Panamin had at first thought they should have two underwriters, one in Adelaide and the other in Melbourne, as it was hoped that the shares would be listed on both exchanges. They had changed their mind on the need for two underwriters wken a well-known Adelaide broker told them that Green and Burchell could handle their Adelaide affairs and a Melbourne broker with a large business had said that an issue of Panamin's size did not require two underwriters. In answer to the Committee's questions, Mr Fox said that the Panamin directors had not made any inquiry of the committee or the executive of the Stock Exchange of Adelaide as to the capacity of Green and Burchell to fulfil the underwriting agreement. Another Panamin director, Mr Wilcocks, said: 'I felt that since we were dealing with a member of the stock exchange that alone gave him a fairly reasonable credit rating'.

In his evidence before the Registrar-in-Bankruptcy, Mr Green said that he had recognised that his firm had, in November 1970, entered into an agreement whereby, at some time during the following five months, it could be called upon to provide $575,000 and perhaps even $500,000. Mr Green also said that the firm could not have provided amounts of that order from its own resources. However, he and his partner had believed that they would not be called upon to do so. They had expected the prospectus to be issued in December 1970, and they had been so confident of receiving public subscriptions for the full issue that they had not taken any steps to obtain sub-underwriters of the flotation. The brokers had expected such a large demand for the shares that they had believed it would be necessary to ration the supply, and under the underwriting agreement they had retained the right to, in effect, nominate all the allottees. Although a copy of the draft prospectus showing Green, Burchell as the underwriter was received by the Adelaide Stock Exchange about 15 December, thereby giving notice to that Exchange of the broking firm's obligations, no effective steps were taken at that time by the Exchange to ensure that the member firm either itself or through sub-underwriting arrangements had the financial resources to fulfill its undertaking (Committee Document 6-4).

The issue could not take place in December, however, as the prospectus was not registered until 25 January 1971. Following the registration, Panamin sent printed copies of the prospectus to the broker-underwriter with the intention of seeking public subscriptions during the period to 26 February 1971. Market conditions at that time were very different from what they had been in November 1970 when the underwriting agreement had been signed, and by 15 January 1971 Green and Burchell had been told by various brokers that they should expect little or no public support for the issue. Tile only conceivable way in which the issue could have proceeded with Green and Burchell as the underwriters was if the firm had made contractual arrangements with sub-underwriters who would have subscribed for the shares not taken up by the public. But in fact no such arrangements had been made, and by January 1971 it was too late to do so. As Mr Fox said: 'They [Green and Burchell] chose to follow up in January when the market ... took a very sharp, severe and somewhat demoralising nosedive'. Faced by the almost certain rejection of the float by the public, the broking firm declined to distribute the prospectuses in the market. In effect, the firm refused to proceed with the issue. A discussion took place between the broker and the company in an endeavour to effect a compromise which would still provide Panamin with some funds to carry on exploration, but no arrangement was reached. At the time Mr Green apparently realised that his firm was in deep financial trouble arising from its other activities. A series of events then took place fairly quickly: Green and Burchell wrote to the company on 4 February repudiating the underwriting agreement; on 3 March 1971 the public became aware of the crisis facing the broking firm when Panamin issued a writ against A.J. Green~ Burchell & Co. for $1,250,000; and on that day the Adelaide Stock Exchange suspended the firm from membership. Later in the same month the partners filed their own petitions in bankruptcy. At the time of writing the $1,250,000 claim lodged with the Official Receiver by Panamin has been recognised for $200,000 (Committee Document 6-6).

Other Reasons for the Collapse

As subsequent events were to show, Green and Burchell's inability to meet the financial commitment arising from its underwriting of the Panamin issue was not the immediate cause of the firm's collapse. The underwriting agreement was only one of the firm's many problems, some of which had been in existence for several years, and others of which had built up in the nine months preceding the collapse. Mr Green agreed with a suggestion by the Official Receiver before the Registrar-in-Bankruptcy that 'the business deteriorated badly' between May 1970 and February 1971. This deterioration, according to Mr Green's estimate, involved a loss of about $100,000. Not surprisingly, the amount by which the firm was overdrawn at the bank had been rising (to about $100,000), and the firm had been trying to obtain finance from other sources. Presumably the news of this attempt to raise outside funds spread among participants in the market, for on 3 March 1971 the President of the Adelaide Exchange heard 'some rumour about a member firm endeavouring to finance its book debts' (Committee Document 6-4). In making inquiries he had visited the office of Green, Burchell & Co. where he was informed that the partners were in consultation with their bankers. At 2 p.m. on the same day Messrs Green and Burchell met with the president, and according to the Stock Exchange, 'confirmed that they had had a lengthy discussion with their bank that morning as a result of which it appeared that their financial position was such that they would not be able to carry on'. 'This situation' we were told 'had arisen quite independently of the Panamin underwriting agreement, and in fact the subject of that agreement did not enter into the discussion at all on that occasion'. After noting the firm's 'low' capital, the Stock Exchange committee then suspended Messrs Green and Burchell from membership later in the afternoon (Committee Document 6-4).

The reasons for the firm's heavy losses in the latter part of 1970 and the early months of 1971 were partly bad debts by share-trading clients and the staff (including an amount of $12,500 owed by one of the several share-trading companies in which Mr Green was a major shareholder), but mainly two disastrous share speculations by the firm itself in its 'arbitrage account'. This was the arbitrage and share-trading account to which we have already referred: it was run by the firm's 'operator' on an arrangement whereby 60 per cent of the profits were to be paid to the staff. The operator at the time was an unsupervised, twenty-year-old employee, and the partners said they had not authorised the two transactions that alone would have substantially crippled their business. In short, the brokers' employees had gambled with a large part of the remaining funds, as the profit-sharing agreement had encouraged them to do, and they had lost.

But well before these last speculations, and before the broker entered into the underwriting of two company flotations, a most improper and injurious practice had arisen within the firm. When the affairs of the partnership were in the hands of the Official Receiver in 1971, it was discovered that since 1969 clients of the firm who had paid about $107,000 for shares bought on their behalf had not received their scrip. Over 240 clients were found to be in this position~ and at the time of the default neither the money nor the scrip was available to meet the liability (Committee Document 6-5). Apparently almost the whole amount had been squandered in financing the firm's unrevealed losses. The Sharebrokers Act, 1945 (S.A.) had specifically required, in sections 4,5, and 6, the maintenance of a trust account to protect investors in such circumstances (Committee Document 6-7), but we received information that Green and Burchell had not had an effective trust account. When Mr Green appeared before the Registrar-in-Bankruptcy he was questioned by the Official Receiver about this aspect of his firm's business, and the relevant parts of the transcript read as follows:

As a sharebroker, were you required to keep any trust accounts?

Yes we were.

And did you keep them?

We did keep trust accounts. We had a trust account but we did not fulfil it.

As a sharebroker, first of all what accounts were you required to keep as trust accounts?

A trust account under the Act.

For what?

Clients that have paid in money for the purchase of shares and they have not been registered.

At the same hearing Mr Green also made a general comment about the keeping of trust accounts among Adelaide brokers:

I think it would be only fair to say a lot of the trust accounts were not being maintained fully because it was a position of disgust to the Attorney-General, and even the detective who came up for these trust accounts, he was completely baffled. I don't think, during the boom, it was maintained as fully as it should have been.

The Registrar: That is only comment.

The Witness: I think it is only fair to tell the Court.

The Committee has also received independent evidence indicating that Green, Burchell was only one of a number of Adelaide firms that had failed to run their trust accounts in accordance with the Act. Mr Green's comment to us on the deficiency in his firm was that it 'was possibly due to scrip staff and other executives selling scrip over the boom period, and this was brought about by inefficiency and confusion during this period'. He also said that 'the auditors ... were free to do a snap audit at any time, so were the Exchange Committee, and at no time was any attempt made to falsify accounts or mislead anybody' (Committee Document 6-1).

In addition to requiring the keeping of trust accounts, the Stockbrokers Act provides in detail for their audit. After completing his inspection, the auditor, under section 8(2) of the Act, is bound to 'send the original of his report to the Registrar and, if the sharebroker is a member of an exchange, a copy of his report to the president of that exchange' (Committee Document 6-7). The report of Mr Green's firm, A.J. Green & Co., for the year ended 30 June 1970, was obtained by the Committee from the Adelaide Exchange, and we noted that although there was no reference to the misappropriation of clients' scrip, it did say that 'The sharebroker's trust account [had] not been utilised as required by section 5 of the above Act in all occasions' and added that 'the trust account funds [were] included in the accounts and assets of the sharebroker' (Committee Document 6-8). Had there been an effective investigation of the firm following this warning of 30 September 1970, the public clients of Green and Burchell would probably not have lost so much in the firm's subsequent collapse.

Disposal of the Proceeds of Sale of Defaulting Members' Seats

One of the last exercises undertaken in this case study was to examine the method by which, in the event of the default of a broker, the stock exchange disposes of the member's 'seat' on the exchange. Under the articles and rules of all the exchanges, a defaulting member's seat may be sold by the exchange and the proceeds distributed according to an order that allows the exchange and the existing members of the exchange to have their accounts settled before payment is made to other creditors. In Green and Burchell's case, the Adelaide Exchange sold the two members' seats (known as shares in Adelaide) for a total sum of $16,00O. From this sum the Exchange first deducted the amount of $800, equal to 5 per cent of the total, for a 'General Reserve as purchasers' entrance fees' (Committee Document 6-4).

From the balance of $15,200, an amount of $9,418.05 was then deducted to settle debts owing by Green, Burchell to the Exchange ($2,247.02) and to other members ($7,171.05). Under its articles (No. 27) the Adelaide Exchange was empowered to allocate either all or part of the balance of $5,781.95 in any one or more of the following five ways:

1. to the stock exchange for its own use and purposes;

2. to the resigning or retiring member;

3. to his estate, family or representatives;

4. to pay a claim by a member or other person;

5. to the member's creditors.

In reply to our inquiry the chairman of the Adelaide Exchange said that 'instead of retaining the balance (as it is entitled to do under Article 27) the committee had resolved to pay it to the Official Receiver'. However, after learning of the Official Receiver's decision to obtain legal advice as to whether the Exchange had acted correctly in retaining certain amounts from the proceeds of the seats, the Exchange 'decided to defer its final decision on the disposition of the balance and informed the

Official Receiver'. At the time of writing the Adelaide Stock Exchange remains of the view that it has acted correctly in this matter, for the chairman's letter to us says: 'The [Exchange] Committee has been advised, and is quite satisfied, that the action which it has taken and which it proposes in relation to the proceeds of the seats is fully justified in terms of Article 27' (Committee Document 6-4).

It will be observed that the effect of this surprising rule, whereby the Adelaide Exchange could dispose of the proceeds of sale of the partners' seats, was to allow both the Exchange and the members of that Exchange to receive payment in full of the amounts they were owed by Green, Burchell well before the firm's former clients received any payment of the amounts owing to them. We also noted (see below) that at present these former clients can expect to receive only a partial settlement of their accounts. In our view, for the members of a stock exchange to ensure precedence for themselves in such a way is a serious abuse of their responsibilities. Apart from the serious inequity of the procedure as between persons, the stock exchanges should as a matter of efficiency have the incentive to take all reasonable steps to ensure that their members remain solvent, rather than run their affairs in the comfortable knowledge that the exchange and its members will enjoy a preferential position in the event of the financial default of a fellow member.

Having said that, we wish to add that there would be less to criticise in this procedure if a stock exchange were simply taking this step before proceeding to meet in part or whole the former firm's deficiency by a payment (that was larger than the sum realised from the seats) from an exchange fidelity fund. However, in Green, Burchell's case, more than two years have passed since the firm's default and no payments have been made from the fidelity fund, and at the time of writing it is not known whether any such payment will be made. It was also drawn to our attention that the total amount by which the liability of the partnership and the partners is expected to exceed the assets is about $464,000 - much larger than the size of the fund under the Fidelity Scheme of about $91,000 (Committee Document 6-9). There is provision within the articles of the Adelaide Stock Exchange for members to be required to pay money into the Fidelity Scheme from time to time, up to an amount of $5,000 a member; and as there are sixty members of the Adelaide Exchange, the total amount that might be raised this way would seem to be $300,000. However, the articles also provide that the total amount which may be paid from the Fidelity Scheme in respect of any one firm shall not exceed $100,000, except with the approval of the members by special resolution. Furthermore, we have been informed that another claim might be made on this Fidelity Scheme to help settle the large deficiency which has arisen in the case of another Adelaide broker who also ceased business in 197 1. It appears at present, therefore, that even if there were a payment from the Fidelity Scheme, this would still leave the former clients of Green, Burchell suffering a substantial loss.

The Failure of Self Regulation

Our investigation of Green and Burchell's business led us to the view that there are serious weaknesses in the methods by which self-regulation is carried out by members of the Adelaide Stock Exchange. The firm's principals were permitted to underwrite large capital issues without being subjected to any special investigation as to whether they had the expertise and financial resources for this activity. When the firm underwrote a $500,000 issue in November 1970, it did not have to follow any stock exchange rules or guidelines to ensure that adequate sub-underwriting arrangements were made or that capital resources were available to meet any commitment. Not till 12 January 1971, when share prices had fallen, did the committee of the Adelaide Exchange question Mr Green about the arrangements he had made to meet a probable shortfall in the underwriting (Committee

Documents 6-2 and 6-4). The firm's financial position weakened irretrievably over a period of about nine months without the matter coming to the attention of the exchange until almost the hour of the firm's collapse, and even then the exchange committee's awareness of the problem did not arise directly from its own regulatory procedures but as the result of the bank refusing further funds. In addition the misuse of a large quantity of clients' scrip and money apparently never came to the attention of the exchange during the firm's existence. It also appears that there was no real attempt by Green and Burchell to reconcile regularly the outstanding share transactions with the firm's interstate agent, and that employees of the Adelaide firm and the Melbourne agent may have come to some arrangement to evade the stock exchange rules in this respect (Committee Document 6-5). In short, the stock exchange's self-regulatory procedures failed to stop a large loss being imposed on over six hundred members of the public who were owed either scrip or money, and if it had not been for the refusal of the bank to provide further funds, and perhaps Panamin's action in issuing a writ~ the business might have continued to trade even longer than it did, thereby imposing greater losses on the public.

The one occasion we know of when the Adelaide Exchange's regulatory procedures brought an aspect of the Green, Burchell firm's affairs to its notice was when the firm's auditor, in September 1970, filed a report that drew attention to certain breaches of the trust account provisions of the Sharebrokers Act, 1945. The Adelaide Exchange's reply to our inquiry as to what steps were taken to follow up that qualified report is as follows:

... I would advise that a summary, all qualified 'audit reports' was considered by the Committee at its meeting on Thursday, 1st October, 1970, and as is the usual practice the President undertook to investigate and discuss the qualifications with the senior partners of the respective Firms.

During his investigations the President paid particular attention to those Member Firms that had had their audit reports qualified in relation to breaches of the Trust Account provisions of the 'Sharebrokers Act 1945', and instructed those Firms that future breaches would not be tolerated. On 12th January, 1971, the President reported to the Committee that he had spoken to all Member Firms whose audit certificates, for the year ended 50th June, 1970, had been qualified ...

(Committee Document 6-10)

In Green, Burchell's case there clearly was no investigation of any consequence by the President of the Stock Exchange, and the general warning that 'future breaches would not be tolerated' proved to be ineffective in enforcing compliance with the stock exchange rules and the law. Public investors are entitled to expect the regulatory authorities to follow more rigorous investigatory procedures in such circumstances rather than rely on methods that are perhaps more appropriate for self-regulation among members of a private club. We may also note that after the Adelaide Exchange had been warned in September 1970 of Green and Burchell's breaches of the trust account provisions of the Act and had failed effectively to investigate the matter, it still proceeded to ensure a preferential position for itself and its members in the subsequent settlement of debts following the firm's collapse in March 1971. In our view this case illustrates the need for a government supervisory body that will not only be specifically charged with the responsibility of investigating breaches of the exchanges' rules and the law, but will ensure that the exchanges adopt rules which are compatible with the public interest.

We also observed that there was no rule of the exchange that prohibited a member firm running a profit-sharing scheme with employees based on the results of an arbitrage and share-trading account run by the firm's operator. The effect of this scheme was not only to imperil the solvency of the firm itself but, in our view, to encourage the staff to seek speculative share-trading opportunities from which they would be the main beneficiaries. Both Mr Green and Mr Burchell told us that neither the stock exchange nor the auditor queried these share-trading arrangements. It is our view~ however, that investment advisers who participate in schemes such as that in operation at Green, Burchell's must, when giving advice to clients, often be tempted to colour their recommendations with a view to providing opportunities for share-trading by the profit-sharing account.

The existence of an account of this kind would seem to encourage a broker's employees to think that they are trading in competition with the firm's clients and in this competitive situation the clients are at an obvious disadvantage. To begin with, the clients must pay a brokerage charge on all their purchases and sales, whereas the staff members do not in respect of the dealings in the profit-sharing account. In addition, the clients are unaware of the transactions taking place or about to take place through the profit-sharing account, so they have difficulty in judging whether or not they are receiving disinterested advice. The clients must also trust the staff to carry out their orders either on the floors of the exchange or elsewhere~ and there is no way they can tell whether their orders are being deliberately delayed to give precedence to the transactions from which the staff stand to benefit. The scope for abuse is obvious, and we cannot condemn this practice too strongly.

CHAPTER 7

INVESTMENT CONSULTANTS, SHAREBROKERS AND SHARE TIPPING

Nature and Growth of Investment Consultants

Stockbrokers are the main advisers to members of the public on their investments in listed shares in Australia. They are also probably the main channels through which recommendations in written form on these securities are disseminated in the market. Nevertheless, in recent years many other types of firms and companies, as well as the Press, have been increasingly challenging brokers in both these roles. Several trading banks and most merchant banks manage share investments on behalf of clients; generally though only for clients of some wealth (holding say a portfolio of about $20,000 and more) or for financial institutions. Moreover, some trading banks and leading merchant banks have a range of other restrictions, usually unquantifiable, on the type of client they will accept. On occasions, for example, they have tended to avoid clients who, in their opinion, are primarily interested in short-run speculation. However, given the large number of companies in Australia which call themselves merchant banks, and the variations in the types of business they perform, it is unlikely that there are many rich investors who cannot obtain the type of advisory service for which they are looking.

For many years, trustee companies have also been acting as share portfolio managers and advisers, though most of their business in this respect comes from their handling of trusts and estates.

In addition to trading banks, merchant banks and trustee companies, a number of firms and companies loosely described as investment consultants, investment counsellors or investment advisers have been operating in Australia. During the last boom in mineral exploration shares, it was quite common for firms and companies to open an office and begin advertising their services as investment consultants. There were no effective restrictions on this activity; practically anyone, regardless of their training or earlier experience in the industry, and no matter how limited their financial resources, could begin advertising, circulating newsletters and tipping sheets, producing charts and managing investors' portfolios. Some consultants went further, and combined all these functions with other activities, such as share trading, option dealing, company flotation, and directing public companies. In no State was there legislation which regulated the extent to which these activities could be carried on together, and the enactment of the Securities Industry legislation in 1970 and 1971 has not in practice altered that situation. At the same time as an investment consultant was engaging in advisory activities on behalf of clients, he could also conduct share and option dealings on his own behalf, or on behalf of family companies. Especially noticeable was the way geologists and mining engineers, with some special expertise in aspects of geology or engineering, quickly expanded their operations to include the management of mutual funds and public companies which invested and traded in all types of listed shares and not just mining shares.

So the range of activities covered by investment consultants varies greatly. Precise definition is impossible. At one extreme there are firms which act solely as advisers to members of the public, and neither directly nor indirectly carry on any other activity to do with the securities markets (see, for example, the evidence of Mr J.D.G. Robinson, Ev. 808-31). At the other extreme, as we have said, there are firms which are involved in most aspects of the markets. The aggregate value of share investments managed by investment consultants, including merchant banks, is not known, but evidence suggests it would be large, running into many hundreds of millions of dollars. The value of share investments managed by firms which confine themselves to this function alone would be relatively small; it appears that about $20 million would be the largest sum managed by any one such firm.

In the course of acquainting itself with the functioning of investment consultancy businesses, the Committee obtained information from a selection of firms, and some of the evidence showed how consultants can make a distinctive and valuable contribution to the efficient working of the capital market. Some of them offer advice to investors for a fee which is geared in percentage terms to the market value of the client's portfolio from year to year. Where consultants do not have other functions or other sources of revenue, such a fee system tends to bring about a common interest between those giving and those acting on the advice. It is naturally in the business interests of consultants to claim virtue in the difference between their system of remuneration and the system prevailing with share-brokers, and to emphasise a degree of distancing in their relations with the brokers. It is to be noted, nevertheless, that members of the stock exchanges do have a substantially different basis for recovering from investors the costs of providing their advisory services. They seldom charge a separate fee for this service, let alone gear it to movements in the value of portfolios; instead, they rely on their brokerage commissions to cover the expenses of carrying out this and their other functions, and to return the firm a profit. Subject to the consideration that individual brokers are liable to lose client business if their advice proves to be defective over a period, it remains generally true that their commission earnings are related directly to the value of a client's turnover, and only to turnover, so that there is an inbuilt financial incentive for brokers to allow their advice to be at least partly influenced by the effect it will have in stimulating turnover.

The need for consultants to maintain independence of judgment and action from sharebrokers is also relevant to the conduct of their business, and it will be seen later in this chapter and elsewhere in the Report that this can be an issue of serious concern. But, first, we may observe that it is hardly practicable for even the most independently minded consultant to avoid all contact with brokers. This was brought out in some of the evidence given to the Committee by Mr J.D.G. Robinson, the principal of the Melbourne consultancy firm, John D.G. Robinson & Associates. Mr Robinson testified that all his firm's income came from fees for managing investments. Clients' cash was not handled, and the firm's advisory activity was not combined directly or indirectly with share trading on its own account, with company promotion, underwriting or sub-underwriting as principals, the circulation of market letters or any form of option or share dealing. Measured by the monetary value of investments managed, most of his business came from pension funds, although the number of portfolios managed for individuals and family companies or trusts far exceeded the number of pension fund portfolios. Between 60 and 70 per cent of the funds managed were under his firm's complete discretion in the placing of buying and selling orders, but even in those cases the firm kept in constant touch with the clients.

Mr Robinson estimated that he and his partners visited 'something like 250' companies a year as part of their effort to gain a first-hand knowledge of the companies' affairs, and he also said they had 'attended 95 annual meetings in the last three months' preceding his evidence to the Committee. In addition to this independent work, however, he acknowledged that his firm drew heavily on the research departments of certain brokers, and he described how to some extent this influenced the direction in which clients' orders were placed among brokers:

Mr Robinson: At this point we rely a great deal on assistance from brokers in the way of research. There is no doubt about that. Our research has not grown, nor has the research of anybody else in Australia grown to the stage which perhaps one or two brokers have reached, yet we have gone further in other aspects of research which brokers have not. We appreciate the research done by many brokers. So certainly there is a time when perhaps business which has no direction at all from the client might go to such people. But that is so only if we are convinced that other benefits will be received by a client. That must be our first concern. If we look back to the percentage growth, if you like, of a client's portfolio, it has to be increased so we must consider that at all times.

(Ev. 813-14)

According to Mr Robinson, his firm still took care to preserve a measure of detachment from brokers who provided research facilities. He described two kinds of offers made to his firm which had been rejected for that reason:

Mr Robinson: ...one broker offered to meet our expenses on an overseas trip, but we refused.

Senator Rae: Why?

Mr Robinson: Because we must not have any associations with the broking fraternity other than a normal placing of business. We must not, because to be obliged to a broker is the worst thing that an investment manager can do.

Chairman: He becomes a prisoner.

Mr Robinson: A prisoner perhaps, but he must be completely removed from any broking activities.

Senator Rae: So you see it is essential that there should not be any conflict of interest so far as your activities are concerned and the activities of others with whom you necessarily come in contact?

Mr Robinson: I believe it is essential.

Senator Rae: So it is a very positive attitude on your part that you have no special associations with any brokers?

Mr Robinson: Very positive. We have been asked to prepare our views and to analyse an investment portfolio for a broker, for a fee. We have been asked to manage brokers' clients on the basis that they do not know, and a broker does not mind paying us. It saves him putting on extra staff. I do not think there is anything wrong with a broker seeking someone to do this, but I think it is very wrong for someone in our position to consider it for a moment.

Senator Rae: Perhaps I should ask you why, although everybody may draw his own conclusions. I would like you to state your reasons for saying that.

Mr Robinson: Because he must not be tied to any broker. We must not be in a position where a broker can say to us: 'But what about the business you have received from us? We have not had much commission.' We might not want our clients to move a security for perhaps six months. That might not meet with a broker's approval during a terribly quiet time when no business is going through. We must be free to refrain from transacting business.

(Ev. 814)

The main purpose of the Committee's examination of investment consultants was not to compare their role in the operation of the securities markets with that of members of the stock exchanges, but to see whether the State government authorities have been any more effective in regulating investment consultants than they have with brokers. The conclusion based on the evidence in this chapter and Chapter 12 is that they have not, and indeed that large areas of these activities, including the relations between brokers and other consultants, do not normally come to the attention of any kind of authority or to the notice of the public. To demonstrate the nature of these areas, it will be necessary to present a fair amount of detailed illustration based on close investigation. Our inquiries have revealed a wide range of abuses arising from the ramifications of consultants as share tipsters, share and option traders, and company promoters, and in this chapter we discuss the kinds of practices which have been taking place. If some of the individual transactions to be quoted seem petty, it will be noticed that the distortions of the market which they appear to involve are often substantial.

In marked distinction from the principles and practices outlined by Mr Robinson, the consulting company with which we are now to be concerned had a multiplicity of activities in the securities markets, including a promotional role in the flotation of one public company that raised $2 million and an important though largely secret role in the flotation of another company that raised $750,000 (see Chapter 11). In the course of a few months following these flotations a substantial part of this $2.75 million was lost. Although not a member of the stock exchange, the consultant's activities were closely connected with the stock market, and at various stages in the company's growth there were close associations with sharebrokers. These associations are described in detail, as they shed light on organisational aspects of both the stock exchanges and the securities market as a whole that must be borne in mind when considering the need for, and the role of, a national regulatory body.

The Multiple Roles of Australian Investment Counsellors Pty Ltd

Establishment of the Company: Financial Assistance From a Broker From the early stages in the life of Australian Investment Counsellors Pty Ltd (A.I.C.), the company was closely involved in the day-to-day share market, and it had seen established a close link with one stockbroker in particular. This association began when the broking firm, Patrick and Company (which changed its name to Patrick Partners in 1970), extended a loan of $5,000 to A.I.C. on 30 September 1968. If $5,000 is not a great amount by some standards, it was symptomatic of the financial needs of Australian Investment Counsellors at the time. The loan was made by cheque, and was arranged by Major Brian Gerard Douglas, Chairman and Managing Director of A.I.C., who first appeared as a witness before the Committee on 23 December

1971. At the time when the Committee first became aware of this loan, several other business associations between A.I.C. and Patrick & Company had become known to us, as well as part of the nature of A.I.C.'s activities, and we inquired in some detail into the circumstances in which the consultant had become linked with the broker.

Senator Rae: How did it come about that (a) you were in need of the loan and (b) you received the loan from Patrick & Company?

Major Douglas: We]l~ the need of the loan was obviously that the $100 paid up capital was not enough really to set up a business of this type. The loan was made by Mr Course, the Melbourne representative of Patrick & Company, when I was discussing with him one day the problems of liquidity that I had in the business because I had not made any significant profits; and the cash flow was not tremendous at the time. He offered to loan me the money at a rate of interest, but required to have lien, as it were, over ten per cent of the capital.

(in camera)

An examination of A.I.C.'s financial affairs at about the time of the loan shows the need for a sizeable injection of new funds into the business. A note to the balance sheet at 30 June 1968 says that A.I.C. began to act as investment consultants in February 1968, and had begun to advertise and to issue circulars late in May 1968; 105 subscriptions had been received by 30 June 1968. At that time the business was financed mainly by a loan of $3,795, and by subscriptions paid in advance amounting to $2,625. The company had an issued capital of $2, and accumulated losses of $433. In the light of this financial position, as well as Major Douglas' own testimony that he was having liquidity problems in September 1968, it seems that the loan of $5,000 at the end of September 1968 was of considerable importance to A.I.C. Major Douglas said that he thought he could have done without the $5,000, but this would have meant doing without carpets and office partitions, and A.I.C. 'would have been slower coming up' (in camera). No date was set for the repayment of the loan, according to Major Douglas.

In A.I.C.'s records an account was opened for Travinto Nominees Pty Ltd, to which $4,990 of the $5,000 paid by Patrick & Company was credited. Travinto Nominees is a nominee company run by Dawson Waldron, Sydney solicitors. The remaining $10 was credited to an account 'Sundry Shareholders' to pay for ten shares in A.I.C. which were issued to Travinto Nominees. The Committee asked Major Douglas to explain the relationship between the loan from Patrick & Company, the issuing of ten shares in his company (equivalent to ten per cent of the issued capital at the time), and Travinto Nominees.

Senator Bae: ...Now, when the original loan was made, the arrangement, as I understand it, was made with Mr Course, on behalf of Patrick & Company, and it was that Patrick & Company would take ten shares as a - lien was the word you used ...

Major Douglas: They did not use that word, but that is the way I looked at it. It was a gentleman's arrangement, Mr Chairman.

Senator Bae: Was there any discussion at that time as to in whose name the allotment of shares would be taken by Patrick & Company?

Major Douglas: They said to issue them in the name of Travinto Nominees.

(in camera)

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Senator Rae: Was it explained to you why they should go into the name of Travinto Nominees and not Mr Course or Patrick & Company?

Major Douglas: No.

(in camera)

To discover who was the beneficial owner of the shares issued in the name of Travinto Nominees, the Committee examined the relevant transactions in A.I.C.'s records. Interest was paid by A.I.C. to Patrick & Company on the loan until it was repaid in April 1970. Repayment was effected by offsetting $5,000 against an amount owing to A.I.C. by Patrick & Company at the time. In A.I.C.'s records the entry was made on 30 June 1970. Also on 30 June 1970, B.G. Douglas' ledger account was debited with $10, and Travinto's credited with the same amount. In the journal the notation made to accompany those entries was 'Balance of account re shares'. In A.I.C.'s share register the transfer of the ten shares held by Travinto Nominees was recorded in January 1971, when the shares were transferred to Major Douglas' wife. But the actual transfer form for that transaction was not completed until November 1971, and it was only then that the scrip was surrendered, the certificate having been kept in the Sydney office of Patrick & Company.

Only one dividend was paid by A.I.C., and that was for the year ended June 1970. It was paid in February 1971, and the dividend on the ten shares we have been discussing was sent to Major Douglas' wife, not to Travinto. As Travinto had been the registered owner of the shares on 30 June 1970, the Committee asked Major Douglas why Travinto had not been entitled to the dividend.

Major Douglas: I suppose they could have been, but I was not going to let them have it.

Senator Rae: Why not?

Major Douglas: Because really they were my shares and I had paid off the loan. I suppose technically, Mr Chairman, they could have asked me for it, but ...

Senator Rae: Well, was the position then that you never regarded the ten shares as being other than a form of security for the loan of ~5,000, having no greater rights, really, than being some ...

Major Douglas: I suppose if they had insisted on a dividend I would have had to pay them, technically. I would have had to pay Travinto Nominees a dividend.

Senator Rae: Yes, and Travinto Nominees would have, of course, paid the dividend to Patrick & Company had they received one?

Major Douglas: Presumably.

Senator Rae: Well, that was for whom they held the shares was it not? That was to your knowledge.

Major Douglas: Yes, no question.

Senator Rae: Well, Travinto Nominees would not have been entitled to hold any dividend?

Major Douglas: No, it passes through as beneficial ownership. Yes. There is no question they did not consider they were entitled to a dividend, I am sure of that. They had the interest on the loan.

Senator Rae: Did you ever discuss it with Patrick & Company?

Major Douglas: Not really, no. It was just the first day they ever did it. They said: 'We will lend you $5,000 and we would like the ten shares put in Travinto Nominees'. I said: 'All right'. At that time I did not really expect to be making any great money anyhow. I did not make that much, as you can see.

(in camera)

From this evidence it was not clear to the Committee who was the beneficial owner of the ten per cent of A.I.C.'s capital which had been held by Travinto Nominees.

Mr Robert Duncan Somervaille of the legal firm of Dawson Waldron, representing Travinto Nominees, was not able to help, either. He testified on 17 December 1971 that Travinto had no records of having taken up shares in A.I.C., nor had Travinto received any share scrip, notices of general meetings, or other communications which showed the company as the registered holder of shares in A.I.C. Mr Somervaille said that his first knowledge of the matter was in or about November 1971, when he was asked by Mr J.A. Keir, a partner of the Patrick broking firm, to execute a transfer of a holding for which a share certificate was produced in the name of Travinto Nominees. Mr Keir informed the Committee that he had made this approach to Dawson Waldron in fulfilment of a telephoned request, in late November 1971, from Mr N.R. Course, a partner of Patricks in the Melbourne branch office. Mr Course asked him to obtain from Travinto a signed transfer of its shareholding in A.I.C. with the name of the transferee left blank (in camera). On this evidence, the action to adjust the record of ownership was made three years after the A.I.C. shares had been put into the name of Travinto. It was also about six weeks after the Committee had raised some general questions during the evidence of a member of the Patrick broking firm regarding the relationship between his firm and A.I.C. (Ev. 2306-7).

The Committee asked Mr Somervaille what arrangements existed between Dawson Waldron and Patricks regarding the use that could be made of Travinto Nominees:

Senator Rae: Was the course of conduct of Travinto Nominees Pty Ltd and Dawson Waldron in relation to Patrick Partners that if they had cause to make use of a nominee company they would feel free to use Travinto Nominees but, hopefully informing you of the details of what was being done.

Mr Somervaille: Yes, as far as Travinto was concerned there had to be a board resolution accepting the appointment. There would not always be formal deeds of trust in connection with it, but there would be a board minute by Travinto accepting any particular offers. There was not anything in the case of Australian Investment Counsellors that we have been able to locate...

Mr Somervaille also explained that

... Patrick Partners formerly Patrick & Company, the professional association, were, and still are in some respects, a client of Dawson Waldron, and Travinto is known to act in the role of a bare trustee for clients who require its services. I can only assume that there must have been some sort of misunderstanding in Patrick

Partners where the right hand did not know what the left hand was doing. This is the only explanation I can offer for it, and there has been some comment passed back, as you can imagine.

(_in camera_)

Mr John Albert Keir of Patricks testified on 17 December 1971 that to his knowledge neither Patrick & Company nor any partner of the firm took an equity interest in A.I.C., although this possibility had been discussed at some stage (_in camera_). He thought that the shares held by Travinto were beneficially owned by Major Douglas or his wife, and that they might have been placed in Travinto's name as a form of security for the loan from Patrick & Company.

Although the reason for the involvement of Travinto Nominees in these financial transactions between Patrick & Company and A.I.C. was not clearly established by the Committee, there would appear robe little doubt that the firm of Patrick & Company played a significant early role in financing the activities of A.I.C. Moreover, whether or not the firm of Patricks was also the beneficial owner of ten per cent of A.I.C.'s capita , the association between the two firms was sufficiently close for Mr N.R. Course, the senior Melbourne partner of Patrick & Company, to attend A.I.C.'s annual general meeting in 1968 and 1969, and the minutes record him as representing Travinto Nominees (see Committee Documents 7-1 & 7-2).

A.I.C.'s Business: The Dissemination of Tips and Rumours

Relationships with Brokers

About mid-1968, Australian Investment Counsellors Pty Ltd was mainly concerned with the preparation and distribution of a circular called _Investograph_, which was a weekly report on a large number of mining, oil and industrial shares. The proprietor of A.I.C. was an eager chartist and many of the comments and recommendations were short and chatty, and were derived from his charts. In A.I.C.'s words, the circular was designed for 'an exclusive group of both local and overseas sharebrokers, investment houses and professional investors' (Investor's Guide, 10 June 1970), and these subscribers were also informed that they could telephone A.I.C. at any time during the day for information on individual shares and on the market as a whole. In practice the subscribers made extensive use of this telephone service, and in the busy part of the boom A.I.C. published a special message asking its clients to keep their telephone conversations 'short and to the point' in view of the 'continuous calls from subscribers seeking our opinion on various stocks' (Investor's Guide, 29 October 1969). A.I.C. also managed share portfolios for members of the public, and to assist in building up this side of the firm's business it distributed information showing the results of its management of a group of portfolios. The client's names were not given, but the periods during which the portfolios had been managed were shown. The Committee observed that one portfolio was shown as having been under management since early 1967, which was well before A.I.C. was formed, but Major Douglas was unable to recall how this apparent inconsistency had arisen.

The cost of Investograph to subscribers began at $600 a year, and was later increased to $2,000 a year. In mid-1970 Investograph was made available to the public, as well as to brokers. Before then, however, another circular called Investor's Guide was prepared especially for members of the investing public at a cost of $25 a year. At the peak of A.I.C.'s business, 2,000 subscribers throughout Australia took Investor's Guide and 150 took the Investograph. In addition, about thirty copies of Investograph were sold to six brokers, Jamison & Co.; Guest and Bell; Ord, Minnett, T.J. Thompson & Partners; D.M. Bennett & Co; Patrick & Company and Hordern Utz & Bode. When asked who took the most copies, Major Douglas said 'Patricks ... because they were spread all over Australia, with an office in each State' (in camera).

The proprietor said that Investograph was based upon 'technical analysis', and Investor's Guide carried a note saying that it was based 'on a unique combination of fundamental and technical research methods'. Yet both news-sheets contained numerous tips and rumours, and predictions of runs and comments on them. Several examples taken from the circulars capture the tone of many of A.I.C.'s comments. In Investor's Guide, 19 June 1969, in a discussion of Great Boulder shares A.I.C. said:

Our man in Kalgoorlie understands that fourteen drill holes have been put down and although there have been disappointments there have also been a number of excellent intersections.

(A.I.C.'s underlining)

The Committee referred this quotation to Major Douglas:

Senator Rae: ... I wonder could you indicate to us what is meant by the expression 'our man in Kalgoorlie'.

Major Douglas: I would say that was from a broker - or a broker's adviser.

Senator Rae: Does that mean it was a broker or a broker's adviser in Kalgoorlie who gave you the information?

Major Douglas: No. The broker in Melbourne.

(in camera)

In Investor's Guide, 8 October 1969, A.I.C. included the following comments in a review of Norseman Gold:

... poised for another run up, and offer good buying around their present level of $7.00.
It is believed that drilling is likely to commence within the next three or four weeks.
Geological opinion is that there is an excellent chance of success.
If good nickel values are encountered this could be a $50.00 stock.

(underlining by A.I.C.)

Again the Committee asked the principal of A.I.C. about his sources of information:

Senator Rae: ... Is that again an example of the sort of information which would not be available to the general public and which was likely to be obtained by you from brokers?

Major Douglas: I would think I would have obtained that from a broker ...

(in camera)

In these examples, and in other instances, Major Douglas made it clear to the Committee that brokers were his main source of information on tips and rumours.

Senator Rae: If we can perhaps take these ... examples a little further we will deal with the Westmex one first which I quote again:

We now wish to advise that we have reliable information to the effect that the company is not going to wait until the end of the wet season to commence exploration work on this prospect.

Have you any idea how you obtained that reliable information?

Major Douglas: I did not write the particular article. I would not be able to say at this stage where I got it from, but I would have got it from broking sources of some type.

(in camera)

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Senator Rae: In other words, if I can put it another way, it is information that you or one of your employees would have picked up in discussion with brokers?

Major Douglas: Yes, I would think so, Mr Chairman. That was the normal trend of the thing, yes.

Senator Rae: That was my next question. Was that the normal situation with this sort of information? Are the two examples which I have read some of quite a number of examples?

Major Douglas: Yes.

(*in camera*)

It was explained to the Committee that A.I.C. took no steps to check the reliability of the information which it received from brokers and which it was distributing in the market:

Senator Rae: ... But information such as that which I have referred to in examples that I have read out, is all of the nature of inside information is it not? It is information which, if it is accurate at all, has come from insiders within the company. For example, take the information on when drilling is about to commence. If it has not been publicly announced it must have come from inside the company.

Major Douglas: Oh yes, I never asked a broker where he got it from. Often it was proffered to you.

(*in camera*)

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Senator Rae: What steps did you take to affirm your belief in the sound basis of the information given to you by brokers?

Major Douglas: Basically, I accepted it.

(*in camera*)

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Senator Rae: By its nature, it is information which is either unreliable or it is insider information. It has really get to be one or the other has it not?

Major Douglas: Yes.

Senator Rae: And the source of that information, so far as you were concerned, was primarily, if not predominantly, from brokers?

Major Douglas: Primarily.

Senator Rae: Primarily. So that brokers were supplying to you information for publication which was either insider information or alternatively was rumour which may or may not have had any basis of reliability.

Major Douglas: But they were also providing that to their clients at the same time.

(<u>in camera</u>)

Subsequently, Major Douglas decided that brokers were the 'predominant' source of his information, not the 'primary' source.

In obtaining information from brokers there were some firms with which A.I.C. had a closer relationship than others: 'the ones that are on the phone all day'. In this connection, Major Douglas mentioned three Sydney broking firms, namely Patrick & Company, A.B.S. White & Co, and Ord, Minnett, T.J. Thompson & Partners. In discussion, he indicated that Patrick & Company came most strongly to his mind. Major Douglas himself regularly called that firm for daily discussions, and he informed the Committee of his reason:

... because if you look at the market and the stocks in it, they had underwritten a tremendous number of them.

Senator Rae: And therefore would have a closer association with the companies; is that what you mean?

Major Douglas: I would not know that.

Senator Rae: What effect did you expect the fact that they had been the underwriters of a large percentage of companies to have?

Major Douglas: They would have more knowledge on the companies than anybody else, one would think.

Senator Rae: Why would they have more knowledge on the companies?

Major Douglas: It is merely to ring the underwriter of a stock if you want to find out, if you can, something about that stock.

Senator Rae: You mean to say that, operating the type of business that you were operating, you would expect one of the best sources of information in relation to the current operation of a company to be the broker who had been associated with the underwriting?

Major Douglas: Yes, but this was not always so, I found.

Senator Rae: But that was an expectation you had which was supported by experience, but not invariable experience?

Major Douglas: Yes.

(in camera)

Major Douglas expected broker-underwriters generally to trade on their own behalf, and to give buying support to the shares they had underwritten. In the following passage, he is referring to a range of stocks which had been underwritten by various firms:

Senator Rae: Again referring to the Investor's Guide of the 19 June 1969, I quote this statement:

'From the viewpoint of the underwriting brokers these floats have been a disaster for their small clients and there could well be some strong buying support for these issues after the tax year ends.'

Can you explain what was meant by that?

Major Douglas: Could I read it in context? Senator Rae: Yes.

Major Douglas: I believe what I would mean by that - and of course you must realise that I am now looking at it over two years later - would be that the float has been a disaster and the small clients and the big clients -the big clients particularly - are selling for tax losses. It would be extremely difficult for a broker to support a stock under those circumstances. With the tax year over he can then start to support it.

Senator Rae: And what would you anticipate the broker would be doing to support it?

Major Douglas: Buying in the market.

Senator Rae: Buying on his own behalf?

Major Douglas: Yes.

Senator Rae: So that you were suggesting there that you were anticipating that brokers would commence market support of particular stocks as soon as the tax year had completed; in other words, as soon as the selling pressure was off.

Major Douglas: Correct.

(in camera)

Although he expected brokers to trade themselves in shares, Major Douglas did not regard this as a factor to consider when deciding what to recommend to A.I.C.'s readers.

Senator Rae: But in any event in assessing the value of information which you received from brokers, you did not take into account in any way the question of what was the broker's interest in giving you the information?

Major Douglas: I am afraid I did not.

(in camera)

When asked about his other sources of information, Major Douglas said:

There was a significant reporting came to me from Myers [Myers & Company]. They are not Australian brokers; they are English brokers who took a lot of trips over the West and they reported to me a lot on what they found was going on.

Senator Rae: Did you pay for that information?

Major Douglas: No.

Senator Rae: Did you provide any services in return for the information?

Major Douglas: They paid a service fee to me.

(in camera)

Major Douglas charged brokers and members of the public for the rumours and tips he passed on to them but he was apparently offended at the thought of paying himself for such information.

Senator Rae: Did you ever pay anybody for information?

Major Douglas: Not that I have any recollection. It would be abhorrent to me.

Senator Rae: Why?

Major Douglas: I just do not think you do those sort of things.

Senator Georges: But you expected people to pay you for information.

(in camera)

Use of the Financial Press

In order to promote his business, Major Douglas advertised A.I.C.'s investment services about once a fortnight, primarily in the Australian Financial Review. These advertisements carried a clear statement of the type of advice A.I.C. was mostly interested in selling, and one advertisement on 2 October 1969, read as follows:

Surge in Selected Mining Shares Forecast. Prepare to profit with A.I.C. predictions. The mining market has turned, the slide is over. Not all stocks will run. You can pick the ones that will by reading A.I.C. Investor's Guide. Based on expert, fundamental and technical analysis the Guide tells you what stocks to buy, when to buy and when to sell .... Accurate predictions published in the past have helped make handsome profits for subscribers and averted heavy losses. Act now. Take out your subscription for $25. You will receive 54 page issues crammed with profitable advice. It is an investment in itself.

Another advertisement on 14 October 1969 had this to say:

Prepare to profit with A.I.C. Guide selection. It is the fastest growing and most popular service in Australia. One successful transaction will pay your subscription for years. Act now .... There is good news to follow. A.I.C. also provides a personalised portfolio management service.

In his testimony Major Douglas confirmed that advertisements which advertised A.I.C.'s role as a tipster of runs were common.

A.I.C. had other associations with the Press. For one thing, Major Douglas himself was an occasional chartist correspondent in the financial columns of The Age newspaper during the period of the Committee's investigations. A more significant, but less obvious, association arose from A.I.C.'s engagement about June 1969 of the part-time services of a financial journalist, Mr Bryan Frith, who was employed by a national daily newspaper, the Australian. From the commencement of this association, the rumours on listed companies reported by Mr Frith in his weekly article 'Fossicking' for the Australian, sometimes dovetailed in with the comments and tips to be read at about the same time in A.I.C.'s news-sheets. In a comparison between Mr Frith's articles in the Australian and A.I.C.'s Investor's Guide during the months from June to December 1969 (over a part of this period Mr Frith was away and there were no 'Fossicking' articles), the Committee found many instances of the same companies being selected for comment in both publications with similar remarks and the repetition of similar rumours. Among the companies involved were Planet Gold, Carr Boyd Minerals, Cleveland Tin, Consolidated Mining Industries, Great Boulder, Alliance Oil Development, North Flinders Mines, Apollo International Minerals, Dominion Mining, Endearour Oil, Scamander Mining and Gold and Minerals Exploration. In many cases, Investor's Guide made reference to a stock after similar reports had appeared in the Australian; in other cases, the first reference appeared in Investor's Guide; and because A.I.C.'s two publications tended to follow certain mining stocks and make continual reference to them, the Australian references to a stock could both precede and follow those in the A.I.C. sheets. It will be indicated shortly how A.I.C.'s published recommendations often appeared in a manner so as to assist A.I.C.'s own short-trading operations both directly and, in association with the Patrick group, through the company Selected Mining Holdings Ltd.

An example of the 'Fossicking' column in the Australian following the comments made on a stock in an A.I.C. publication is the following sequence of references to Scamander Mining Corporation:

On 5 June 1969, Investor's Guide said:

We believe that there could be some interesting new developments with this company shortly. It would not surprise if the present run up continues to about $0.60 or more.

On 2 July the 'Fossicking' article, under the heading 'Scamander gets highly coveted WA claims', carried a bullish and relatively long comment on Scamander, which said, among other things:

It is believed the company is hopeful of obtaining small mineral claims in the Pilbara region, further north. The claims will cover several minerals including nickel, uranium and copper.

Then, on 17 July, Investor's Guide contained another commentary on the company, which said:

It has more than justified our enthusiasm with a sharp gain recently to a high of 92 cents.

It was also reported that:

There are suggestions that the company is hoping to obtain mineral claims in the Pilbara region of W.A. for nickel, uranium and copper. If successful, it would add another string to the bow.

And on 23 July, the 'Fossicking' column, under the sub-heading 'Scamander in beach sands', said:

It is thought the spread of mineral interests has now been extended to beach mineral sands ... The ilmenite in the area is said to have a low chrome content which would make it saleable if sufficient quantities can be proved. Rutile and zircon are also present.

Another example of the 'Fossicking' article following up a report in Investor's Guide occurred with Gold and Minerals Exploration N.L. (GME). On 13 August 1969, the Guide had a substantial review of GME saying it was

a stock of tremendous speculative appeal .... The shares are not however for the faint hearted ... The timing of the purchase is therefore important ... A further weakening to about $3.25 is a possibility and this could prove a rewarding entry point for the speculator or trader.

On 3 September 1969, the 'Fossicking' column turned its attention to GME under a heading 'Another look at GME'. Included in the article were the following remarks:

Followers of uranium stocks could be forgiven if they were somewhat bemused after reading the report from ... Gold and Mineral Exploration NL, yesterday morning ... To many [the assay] would mean nothing ... However, if the percentages are converted back to a lb per ton basis it transpires that the assays averaged about 2 lb to slightly more than 9 lb to the ton. That is a very high assay. Yet it is plain the market was confused as GME shares lost ground yesterday to close at $3.00.

Another case of identical thinking and similarity of expression in the 'Fossicking' column and an A.I.C. publication occurred on the same day in the case of Cleveland Tin N.L. On 6 August 1969 Investor's Guide had a special review headed 'Cleveland Tin - Promise At Last Fulfilled' and strongly recommended the shares with these comments:

at about 80-85 cents has minimal downside risk and with a strong possibility of a run up to over $1.50 in the medium turn.

and also

our fundamental evaluation of the share price suggests that it could rise to $1.45. Our technical appraisal of current market action suggests that the price could also rise to this level and in fact probably exceed it.

The A.I.C. analysis of the company included the following remarks:

... the greatest difficulty has been in achieving the predicted 60 per cent recovery rate. There are signs the company is now working around this figure so that a marked improvement in revenue can be expected ...

In the first eight months of the financial year the company ran up losses of around $200,000 but in June Directors said they expected the improving operating results and better metal prices were likely to result in a small profit for 1968/69. This on its own would indicate the company was earning ... at a yearly rate of more than $600,000.

The Board is somewhat close about the recovery rate being obtained, but it is believed that it is now very close to the predicted 60 per cent If a 50 per cent average recovery rate is assumed for tin ... [and] if copper recovery has improved to 50 per cent ... on present metal prices the tin would generate annual revenue of around $3 million and the copper about $1 million ... adopting the same costs as incurred in the December half, costs for 1968/69 would work out at around $3.7 million. This would indicate that the company could earn as much as $400,000 for the latest year ...

In the Australian's 'Fossicking' column on 6 August 1969, under a sub-heading 'Cleveland on road back', Mr Frith's report included the following:

... probably the major drawback has been the effort to to obtain the tin and copper recovery rates forecast ...

In 1967-68 Cleveland incurred a loss of $762,OOO and in the first eight months is said to have lost around $200,000. Directors have said the company then began earning profits and it was 'not unlikely' a small profit would be achieved for 1968-69.

This suggests the company is earning at an annual rate of at least $600,000 ...

In 1967-68 recovery rate of tin was 40.1 per cent (60 per cent forecast) and copper 19.2 per cent 70 per cent predicted).

The tin recovery is believed to now be around the target level while directors have stated it was working on improving copper recovery.

If tin recovery was an average of 50 per cent and copper 40 per cent, the company would have generated revenue of about $3.6 million. Taking a line through the costs for the first half-year a full year's operating costs would be around $3.7 million ...

A 50 per cent recovery for copper would lift revenue almost $400,000 more so that the small profit forecast may be better than the market expects.

The terms on which Mr Frith was engaged by A.I.C. provided for his being paid a weekly sum of $20 to assist in preparing A.I.C.'s publications. On one occasion Mr Frith also apparently shared in A.I.C.'s profits, though not on a formal basis, when in December 1969 he received a sum of $400, which was entered by A.I.C. in its cash book as a 'bonus'. The relevant part of Major Douglas' testimony on Mr Frith's relationship with A.I.C. is as follows:

Senator Little: Regarding Frith and the Australian, were there ever articles in the Australian to back up the information that had been distributed in your sheet - the advice issued by you?

Major Douglas: There was sometimes an article in the Australian at about the same time, but normally I picked the stock rather than Frith.

(in camera)

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Senator Little: You were in a pretty happy position with the Australian articles in that case, were you not? The fact that the Australian articles more or less backed it up would give more authenticity to your tip sheet, if I could call it that.

Major Douglas: Well, I picked the stock rather than the Australian. I would not for one minute suggest ...

Senator Little: You did say that there were occasions when the Australian ran articles that more or less backed up what had been said. As it was emanating from the same adviser one of course must expect this.

Major Douglas: Yes, but it was not the norm.

Senator Little: Thank you.

Senator Rae: When you say that you picked the stock rather than the Australian, do you mean that the Australian would publish articles about stock which was selected by you?

Major Douglas: Yes. I meant I would ring Bryan Frith and say: 'Give me all the information you have got in your files about Mount Isa'.

Senator Rae: And if he wrote something for you he might take the opportunity to write it also for the Australian, is that what you meant?

Major Douglas: Well, he could, but he is not that sort of journalist, he is a man of great integrity in my mind.

(in camera)

Mr Frith has informed the Committee that the stocks on which he was to write for Investor's Guide were chosen for him by A.I.C. from material suggested by its Investograph technical service (Mr Frith's letter to the Committee of 10 February 1973, Committee Document 7-3). He was not engaged to write for Investograph. Some months after he began to supply copy for Investor's Guide, A.I.C. started to reproduce some of his reports in Investograph, 'but I at no stage actually prepared any copy for that publication,' Mr Frith said. Mr Douglas had wanted someone to supply 'fundamental details' about stocks, as the Investor's Guide was being sold on the basis that it was a combination of 'fundamental and technical research methods'. Mr Frith said: 'I was recommended to Mr Douglas by Mr Roy Course, [Mr N.R. Course] a partner in the sharebroking firm of Patrick & Company, who was formerly Finance Editor of the Melbourne Age when I worked there.'

In his explanation to the Committee of his association with A.I.C., Mr Frith said that the material he supplied was often altered for publication. Statements and rumours which he had not included were sometimes inserted in copy he had prepared, and recommendations to buy, sell or hold shares were entirely those of A.I.C. He said it was more usual for a reference in the 'Fossicking' column to precede one in Investor's Guide than to follow it. Mr Frith's letter mentions the latter part of the relay sequence of references to Scamander Mining which we have noted above. He says that the 'Fossicking' column's comment of 23 July 1969 dealt with new developments which were not in the Investor's Guide piece of 17 July. The Committee would think that this sequence has to be taken as a whole for purposes of assessing the possible value to A.I.C. of the lihk with the daily newspaper. Speaking generally, we have found a pronounced similarity between the content of A.I.C.'s tipping sheets and the 'Fossicking' articles.

In the case of Major Douglas' contributed articles as a chartist expert for The Age, we have not found significant evidence of co-ordination between these comments on shares and the contents of contemporary A.I.C. publications or A.I.C.'s share trading. The identity of The Age's correspondent was made known to its readers, and this association doubtless helped to promote Major Douglas' standing in the business of investment consultancy.

'The Money Show'

As a method of advertising A.I.C.'s activities before a much wider audience than that usually available to an investment consultant, Major Douglas, in January 1970, joined with Mr Bryan Frith in a weekly television programme called 'The Money Show'. The third member of the panel was Mr Timothy Edward Paterson Hewat, who was both the organiser of the 'Show' and its compere. The Committee was told that Mr Hewat was not a client of A.I.C., but on several occasions during November 1969 and January 1970, Major Douglas offered sBares in new flotations to Mr Hewat, and these were taken up by an A.I.C. subsidiary and sold on Mr Hewat's behalf for a profit. The same A.I.C. subsidiary also acted once in this capacity for Mr Frith. Major Douglas also said that Mr Hewat advised him on advertising and assisted him in writing advertisements (Committee Documents 7-4 and 7-5).

During the fifteen-minute 'Money Show' program, which continued until 25 May 1970, comments were made on the share market, recommendations were given on individual shares, and the panel also bought and sold stocks for the 'Show'. According to information given to the Committee, these purchases and sales took place before the television program was shown, at which time the transactions were discussed. Major Douglas told us that he believed there were 'backers' of the 'Show' who had agreed to provide $5,000 for the speculative trading, with the profits to go to the 'Friends of the Queen Victoria Hospital', but he did not know the names of the 'backers', nor was he aware who paid for the television time, or who were the sponsors (Ev. 2465). Other inquiries by the Committee failed to disclose any firm arrangements covering the provision of funds for share trading.

The buying and selling were carried out by Messrs Douglas and Frith, and most of the orders were directed to Ian Potter & Co. To begin with, these transactions were entered in the name of 'The Money Show', but later they were recorded in an account of a Mr Roger Harold Titus, a fictitious person with an address the same as Major Douglas' home address. Mr Douglas said: 'I signed for Titus. I did not believe it was an irregular thing to do. If it is, I am surprised' (Ev. 2464) and he added that the idea had been suggested to him by the broker so as to avoid 'a leakage of information amongst the people on the stock exchange floor' (Ev. 2464). The senior partner of Ian Potter & Co., Sir Cecil Looker, told us in writing that he was unaware of the use of 'the code name', and he also said that 'in March 1970, [Ian Potter & Co.] indicated that [it] was not prepared to do any further dealings with this client'.

Major Douglas informed us that the shares recommended on 'The Money Show', add bought for 'The Money Show', were not shares that were tipped at the same time in A.I.C.'s market circulars (Ev. 2465-66). In fact, our later investigations showed that there was an obvious co-ordination between 'The Money Show' and A.I.C.'s publications. As an example, for the first appearance of 'The Money Show' on 2 January 1970, shares in Gold and Mineral Exploration were bought at $4.60 each. In a subsequent issue of Investor's Guide on 14 January 1970, Gold and Mineral Exploration shares were strongly recommended:

Another of our stocks for 1970. It ran up sharply last week to as high as $10.00 and is now in a normal downside reaction. Support could well come in for it around the $8.50 level and it appeals at this price.

On 11 February 1970 Investor's Guide again tipped the shares, describing the stock as 'obviously a favourite with this investment service'. Part of the commentary read as follows:

... it is our view that it may only be a matter of time before the go ahead on the project is announced - perhaps quicker than most people think ... Any move in the future above $9.00 on heavy volume would suggest the start of the next advance and could carry the price to somewhere between $15.00 and $20.00.

On 12 and 13 February 'The Money Show' sold its holding at between $7.40 and $7.60 a share. In mid-1973, the shares stood at 8.5 cents.

Our investigations revealed that there was not only an obvious connection between the tips contained in A.I.C.'s publications and the share purchases made for the television program, but a further connection between both these aspects of A.I.C.'s affairs and A.I.C.'s own share trading, which Major

Douglas regarded as an 'adjunct' to his main business. For instance, on 17 December 1969, when A.I.C., through a subsidiary, was holding Platina options, bought in November 1969 at 50 cents each, Investor's Guide tipped the shares to rise from 85 cents to $1.30. On 6 January 1970, 'The Money Show' bought Platina options at $1.00, and so presumably gave a further impetus to the market price for this security through the public discussion of the transaction that took place on the air. At about that time, A.I.C. unloaded its own holding of shares on the market, and a few days later, on 12 January 1970, 'The Money Show' sold its options at between $1.60 and $1.70 each.

Five other examples of the similarity between A.I.C.'s share trading and 'The Money Show's' trading may be quoted to illustrate the tendency. If no single transaction involves great amounts of money, the cumulative effect is striking, and the share price movements involved in some of the 'turns' had definite market significance. The examples are as follows:

(1) On 31 December 1969, 'The Money Show' bought 1,000 Mallina shares at $1.50, which were then sold on 6 January 1970 at between $2.00 and $3.00 a share. A.I.C.'s share-trading records show a purchase of another parcel of 1,000 of these shares at $1.50 each, also on 31 December, and a sale of the holding at $3.00 a share, again on 6 January 1970.

(2) On 24 December 1969, A.I.C. bought 5,000 shares in Australian Consolidated Minerals at about $1.05 a share; and on 31 December 1969 'The Money Show' bought another parcel of the shares at $1.25 each. In this case, on 21 January 1970, Investor's Guide also came out with a review and recommendation of the shares.

(3) On 2 February 1970, A.I.C. bought 5,000 shares in Eastern Copper at $1.00; on 3 February 'The Money Show'

bought a parcel of the shares at $1.01 each.

(4) On 9 January 1970, A.I.C. bought 50,000 Flinders Petroleum shares at 10 cents each; on 5 February 1970 'The Money Show' bought a parcel of the shares at 16 cents each.

(5) On 30 January 1970, A.I.C. bought 2,000 Leichardt shares at 95 cents each; on 17 February 1970 'The Money Show' bought shares in this company at $1.55 each.

A further example of the interlinking of A.I.C.'s various activities involving, in this instance, not only 'The Money Show', but also Mr Bryan Frith's weekly article called 'Fossicking' in the Australian, is as follows:

On 12 November 1969, A.I.C. subscribed to the public issue of Northern Mining, acquiring the shares at 20 cents each and also a number of options. In Investor's Guide, 10 December 1969, when the shares were $1.05, they were tipped as follows:

... the price has moved up sharply and in our opinion will continue to do so. It is understood interesting developments could be announced by the company within the next week or so.

On 17 December, Investor's Guide had an extensive coverage of Northern Mining under the heading: 'Northern Mining - A Stock of Great Promise'. The company was described as 'a most interesting new listing' and, among other comments, A.I.C. said:

Although there has as yet been no indication from the company, it us understood that Northern Mining could be interested in a strategically located copper prospect in South Australia.

On 24 December, the 'Fossicking' article contained a heading 'Market is too cynical on Northern Mining'. Northern Mining was described as 'shaping up as an interesting company' with 'many interesting prospects underway', all 'highly promising at this stage'. The author went on to report that 'it is believed that Northern has been fortunate to obtain areas which come right up to where B.H. South (which holds 51 per cent of the project)is working [in South Australia] and at which the latter company was itself looking with interest'. The article went on to report: 'it is said that values of up to 20 per cent copper have already been obtained'.

On 29 December, A.I.C. sold part of its holding of options at $1.00 each. Then, on 31 December, a number of the same options were bought at prices between 95 cents and $1.00 for the first appearance of 'The Money Show' on 2 January 1970. On 13 January 1970, A.I.C. sold its remaining options at $1.00 each.

In the Committee's view there is little doubt that 'The Money Show' operated as a method of making known Major Douglas' and A.I.C.'s names to a larger number of investors. In addition it was also used as a means of stimulating the demand for shares in which A.I.C.'s clients and A.I.C. itself were trading. The brokers through whom 'The Money Show' dealt were not paid by the 'Show' as the purchases were made, there being no funds forthcoming from the putative 'backers', so the trading was dependent upon the brokers' credit. To begin with, profits were made, but eventually the accounts with Ian Potter & Co. showed a loss of $3,643, an amount which A.I.C. cleared with its own cheque. In Mr Hewat's words this was 'fair enough' as 'their [A.I.C.'s] return was considerable publicity from the show' (Committee Document 7-4).

A.I.C. as a Share Trader

The share speculations of Australian Investment Counsellors Pty Ltd took place through a subsidiary, Darken Investments Pty Ltd, which was described by Major Douglas as 'my trading arm'. Darken traded in its own name and also through two other accounts, Palm Springs Investments and Lakeside Investments, neither of which was registered as a business name. We were informed that the reason these two additional trading accounts were opened was that there were long delays in what was described as the 'settlement' by brokers of the purchases and sales made by Darken, and in ways not made clear to the Committee these delays could be shortened by having two other accounts (Ev. 2466). Darken began trading in February 1969, and in the period to 30 June 1969 purchases and sales totalled about $68,000. In the financial year 1969-70, share trading became a regular part of the A.I.C. - Darken business, totalling about $430,000 for the twelve-month period. Five stockbrokers handled most of the transactions over the seventeen months from February 1969 to June 1970: Patrick & Company, $214,688; Jamison & Co., $116,041; Ian Potter & Co. $76,429; W.J. Baker & Co, $47,926; and Guest and Bell, $25,625.

The volume of Darken's buying and selling responded fairly promptly to changes in the general level of activity in the market, though the mechanism through which these responses came about was not just a simple one of the company taking advantage of the greater trading opportunities as market prices generally increased, but also involved A.I.C. in its role as a tipping agent. For instance, as the Poseidon mineral share boom soared to greater heights at the close of 1969 and in the early months of 1970, A.I.C. benefited from a heavy inflow of subscriptions for its news-sheets, and this money was immediately re-directed to Darken for the purchase of shares in the market. A kind of circular process was at work~ with the speculative market feeding upon itself, so that while the news-sheets of consultants and others were helping to fan the fires of the market, profits from the increased circulation were also providing the writers and publishers with cash resources to play the market themselves. But as we have suggested in the previous section, the link between the two sides of A.I.C.'s business - the circulation of tipping sheets and share trading - was not just a case of the former activity providing funds for the speculative purchases. It was more involved than that. It appears to have been part of the plan for Darken to buy shares of companies which were later to be strongly tipped or recommended by A.I.C.'s Investograph and Investor's Guide, and not to tell the clients and readers of the market circulars of A.I.C.'s interest in the stocks. For example, during the period September 1969 to January 1970, Darken bought the following stocks just before strong recommendations were published in Investor's Guide:

Western Titanium:

bought 22 September at $5.00; recommended 24 September:

... we have carefully examined the market action once again and report that an ultimate rise to around the $8.00 level is possible.

Norseman Gold:

bought 7 October at prices between $6.80 and $7.50; recommended 8 October:

another stock with tremendous potential...
poised for another run up ...

Darken sold these shares on 10 October at $9.10.

Australian Wide Mining:

bought options 14 October at about 21 cents; recommended 22 October when price of options 27 cents:

the chart of this stock is beginning to look extremely bullish ...

Dominion Mining:

bought 5,000 shares 13 October at about 36 cents a share; recommended 15 October:

it would not surprise to see a short term move to over 50 cents.

Also recommended 22 October:

... in a very strong uptrend. These are targets at 60c. and about 80c.

Darken sold these shares on 30 October at 42 cents a share.

Hawkstone:

bought 5,000 shares 30 October at 67-68c. a share; recommended 6 November.

In Sydney yesterday it ran up to 80c .... There is a short term target at about $1.00 and another at around $1.20.

Darken sold these shares on 25 November at prices between 78 and 83 cents a share.

Many other examples could be given including Great Northern, Hill 50, Endeavour, Bounty, Bridge, Target Petroleum~ Australian Antimony, and Coastal Rutile.

During the financial year 1970-71 (the period in which A.I.C.'s gross revenue from its various newsletters and management services reached a peak of about $111,000), Darken held Comalco, Mincorp, Leichardt, Sturts Meadows, I.M.C., Conwest, Selcast and Castlereagh while each stock was repeatedly recommended with often extensive coverage in A.I.C.'s circulars. These recommendations were frequently accompanied by tips from apparent insiders, and by suggestions of the need for urgent action if buying opportunities were not to be missed. For example, on 2 October 1970, while Darken was holding Leichardt shares, the comment on the shares in *Investograph* was:

There is also likely to be good news from the field from this one.

On 6 October 1970 *Investor's Guide* recommended Sturts Meadows while Darken held the shares. The comment was:

Sources in the field are adamant that McPhar's [McPhar Geophysics Ltd] are very hopeful about the proposed programme at Foxes Find.

(A.I.C.'s underlining)

On 20 November 1970, while Darken held shares in Conwest, A.I.C.'s comments on the market in this share were:

Being so 'thin' it could well increase in market price by about $1.00 very quickly.

And on 27 November 1970:

It is a MUST buy for the speculator who is prepared to be patient.

Our investigations lead us to conclude that it was a common occurrence for A.I.C. to tip the shares it had already bought, and Major Douglas did not disagree with this conclusion (Ev. 2468). His comment was that it was 'inevitable' that A.I.C., being a trader, would buy the shares his charts would suggest were going to rise (Ev. 2468, see also his letter 7 July 1972, Committee Document 7-6). However, in our opinion many of the statements in the news-sheets were tips and rumours (often underlined), and these clearly were not based on the sober interpretation of statistics or charts. It was certainly not 'inevitable' that A.I.C. should combine trading with the circulation of these share-tipping sheets, nor was it 'inevitable' that the share buying should just precede the release of the circulars to clients and brokers, nor that there should have been no disclosure of A.I.C.'s interest to clients and readers of the shares being recommended. We find it hard to believe that A.I.C. did not allow its comments in its news-sheets to be influenced by the fact that it was itself an active share trader.

A.I.C. as a Company Promoter and Manager

A third aspect of the business of Australian Investment Counsellors Pty Ltd, complementing the activities of share advising and share trading, was referred to by Major Douglas as 'portfolio management'. In this capacity A.I.C., for a fee, managed other people's investments. Between about 50 and 60 clients looked to A.I.C. for this advice, but the volume of funds involved was relatively small, amounting to about $700,000. On the face of it, when Douglas, together with A.I.C., promoted and floated the public company Selected Mining Holdings Limited, thereby raising $2 million from the public, it was a major step in the expansion of A.I.C.'s business as a portfolio manager. According to the prospectus, the directors intended to pursue a wide range of investment and mining activities with A.I.C. as the manager of the share portfolio to be established 'to provide shareholders with a sound spread of investment'. A closer inquiry was to reveal, however, that from the earliest days of Selected Mining's life as a listed company, large-scale share speculation, conducted substantially on a 'discretionary basis' by the broker who agreed to underwrite the issue, was to be the primary purpose of the flotation. Although A.I.C. wad described as the company's 'expert' manager, in practice it appears that the management of a large part of the company's assets was to be in other hands. Nevertheless, A.I.C.'s role was to be more than that of a passive functionary, for we also discovered that share purchases and sales made on behalf of Selected Mining were, from about the time trading began, co-ordinated by A.I.C. with the tips and recommendations circulated in the A.I.C. tipping sheets to which we have already referred.

Selected Mining Holding's Prospectus

Selected Mining's public issue took place in November 1970 with the Patrick sharebroking firm, which had changed its name from Patrick & Company to Patrick Partners during 1970, acting as underwriter. A total of ten million shares of 20 cents each were offered, and for every two shares allotted the applicants obtained an option to subscribe at par for one additional share any time up to 30 September 1975. One million shares were reserved for the clients of A.I.C., and about 90 per cent of the portfolio management clients bought them. However, the amount subscribed in this way was small, about $42,000, and most of the funds came from public subscriptions and clients of the underwriter. After the issue, Selected Mining Holdings had 3,856 shareholders, of which 2,606 held less than 500 shares each. Major Douglas was the chairman of the company and, according to the prospectus, A.I.C. was appointed manager for five years to advise on 'takeovers, mergers, acquisitions, underwriting, share placements and other activities related to a merchant finance house'. A.I.C. was to be reimbursed for the administration costs and paid quarterly a fee equal to one quarter of one per cent of the first $1 million managed and one eighth of one per cent of the balance of the net assets of the company calculated at market value. The objectives of the company were set out in the prospectus under the chairman's report, and it was specifically stated that the directors' policy would be:

* To invest in mining, oil and industrial shares with a view to securing shares with above-average growth prospects.

* To trade in shares, options, and other securities.

* To engage in mining activities on its own account or in association with other companies, firms, syndicates or persons.

* To form mining or oil companies and where considered appropriate to offer shareholders direct participation in any such entities.

* To participate in take-overs, mergers and acquisitions; to underwrite or sub-underwrite share issues; and to engage in share placements and issues of shares and options.

* To engage in short term money market lending; to arrange fixed interest debenture or mortgage lending; and to engage itself generally in merchant finance.

Major Douglas himself, in testimony before the Committee, summarised the objectives as 'share trading, to enter into mining exploration activities and to act as a merchant bank'. He went on to say, however, that it was planned from the beginning of the discussions on the flotation that share trading would be the company's primary activity, and it was also recognesed by Major Douglas that this share trading would be carried out mainly through the company's underwriter.

Senator Rae: And why would they [Patrick Partners] be interested in underwriting a company which was possibly to engage in activities in the short-term money market or as a merchant banker when they already had their own merchant banking associations direct and a string of companies which they had already underwritten which were engaged in similar activities?

Major Douglas: Well ...

Senator Rae: Could I shorten it by saying this to you? Was it the prospect that this company was to engage in large scale share trading that was the main attraction to Patrick Partners in underwriting it?

Major Douglas: I would say that is right.

(in camera)

The Committee was informed that the reason why share trading had not been emphasised in the prospectus, in a way which would have disclosed the degree of importance the promoters and directors attached to this activity, was to avoid Selected Mining being classified by the regulatory authorities as an investment company. Such a classification would, among other things, have required a more detailed disclosure of the company's investment intentions and substantially limited the directors' scope for borrowing, underwriting and investment. Any holding of ordinary shares in another company would have had to be disclosed and would have been limited to five per cent of Selected Mining's funds. In addition a complete list of all purchases and sales of shares would have had to be published, together with a statement of the brokerage paid.

Who Were the Real Managers of the Company's Funds?

After issuing the prospectus, scarcely any time was to pass before Selected Mining's directors, Messrs B. G. Douglas, J.R. Abbott, E.E. Falk and A.W. Muddyman, took the necessary forma] decisions that deeply committed the company to what soon turned out to be its disastrous career as a share speculator. On 7 October 1970, about one week after the registration of the prospectus, the directors met with a representative of Patrick Partners, Mr R. Gottliebson, and agreed to obtain an overdraft of up to $500,000 to enable share trading to proceed (Committee Document 7-7). At this time the prospectus was still on the market and the capital raising of $2 million was not yet available for spending. In addition, in a discretionary share-trading account run in the Sydney office of Patrick Partners, dealings had already begun on behalf of Selected Mining on 24 September 1970, and these purchases had to be paid for. By 20 October 1970, two discretionary trading accounts were being run by two investment advisers in the broker's Sydney office, and on that day $200,000 was paid by Selected Mining to each account.

At the next meeting of Selected Mining's directors on 2 November, again with Mr Gottliebson present representing the broker-underwriter (he was appointed a partner of Patrick Partners on 13 October 1969), it was reported that the bank overdraft had been arranged for $100,000. At that same meeting Mr Gottliebson was appointed an alternate director for Mr Falk until 23 November 1970 (Committee Document 7-8). To complete the web of share-trading associations which was being established with Patrick Partners, a third trading account was opened with the broking firm's Melbourne office, where dealings began on 2 October 1970. The difference between this Melbourne account and the others, according to Major Douglas, was that it was not run by the broker on a discretionary basis.

Douglas' explanation of the need for the discretionary accounts was that:

In a surging market, such as existed in September/October 1970, the market gets away from anybody who is not closely connected with the floor, and the only people who are closely connected with the floor are the brokers.

(in camera)

The extent to which the investment advisers in the Sydney office could rely on their own discretion in deciding what to buy and sell seems not to have been precisely defined, but in his testimony Major Douglas said that the discretion was not 'total', and added that the brokers were 'required to contact us at A.I.C. and discuss the stock that they were going to buy, except those that they decided to purchase during the day in a running market' (in camera).

When we were discussing these Selected Mining discretionary accounts with the senior partner of Patrick Partners, Mr Max Richard Laidley Dowling, he also told us that there were problems of defining the term. In his experience there were, in general, two ways in which brokers were usually involved with discretionary accounts: the most common way was when a broker was asked, say, to buy a share, but to withdraw the order if he believed it in the client's interest to do so. The second way was when a broker was asked to take decisions on what to buy or sell for a client, to act on behalf of the client in implementing those decisions, and to advise the client afterwards, within a day or so, of what had been bought or sold. It appeared that the two Selected Mining accounts fell into the latter category (Ev.2309).

As the funds became available to Selected Mining from the public issue, the directors placed large amounts on deposit with Patrick Partners: $500,000 on 23 October, and $1 million on 4 November, before making further commitments to the stock market (Committee Document 7-9). According to Major Douglas, in addition to the two discretionary amounts in Sydney, a further $140,000 was handed over to four other broking firms - Jamison & Co., John N. Robertson, Thompson & Co., Hartley Poynton & Co. and Guest and Bell - to be used at the discretion of these brokers for share trading. So at this early stage in the company's life the directors were well on their way to carrying out their main objective of using shareholders' funds for stock exchange speculation. Over $600,000 was already earmarked for this activity and, as we shall show, this was shortly to be increased by an allocation of another $500,000 to the purchase of shares in an investment and share-trading company closely affiliated with Patrick Partners. At about this time it is doubtful whether A.I.C. could be regarded as the effective investment manager of a large volume of the company's funds, if it ever had been. For although A.I.C. had the long-term management contract at a rewarding fee, the investment decisions affecting a substantial part of the company's capital had now been virtually handed over to a group of stockbrokers and~ in particular, to the broking firm which had raised the $2 million in the flotation.

From the point of view of Patricks, the benefit from having such a compliant company client, apart from the underwriting fee ($75,000), was the brokerage revenue arising from the share turnover carried out mainly in the discretionary accounts. Between the time discretionary trading began in late September 1970, and 27 January 1971, when the board of Selected Mining changed, purchases by the two Sydney discretionary accounts amounted to $455,000, and sales to $395,000. Including dealings in the third trading account run in Melbourne, sales and purchases by Patricks on behalf of Selected Mining Holdings totalled approximately $975,000 in that short period following the flotation. During those few months, therefore, the broker-underwriter was able to generate substantial commissions from the Selected Mining company.

From the viewpoint of the public investors in this flotation, however, the record was soon to be seen in a different light. By 22 January 1971, about $140,000 had been spent on preliminary and formation expenses and on running the company, and the various share speculations had reduced the value of the remaining funds by about $322,000. On the basis of market values, a further $75,000 had been lost on the purchase of shares and options in a company called Rimibo Resources Limited. Within about four months of the public issue, and only two months after listing, these losses and expenses had reduced the $2 million raised from the public by about $537,000.

In all this gambling, A.I.C.'s money was not at stake, for neither A.I.C. nor its share-trading subsidiary had taken up any shares in the Selected Mining float. On the other hand, A.I.C. had been 'granted' an option to subscribe for 800,000 shares at 20 cents each at any time after one year but before 31 March 1975 'in consideration of ... entering a Management Agreement ...). In other words, A.I.C. had been able to wait and see how the speculation turned out before committing any of its own funds. Major Douglas seemed well aware of A.I.C.'s advantageous position, for when we pointed out how A.I.C. stood either to gain a lot or to lose nothing, his reply was: 'You said it' (Ev. 2474). In fact, as we have seen, the trading involved a major loss which was borne by the public shareholders, not by A.I.C. But nowhere in the prospectus had the public been given a fair indication by either the Selected Mining directors or the company's broker-underwriter that they would be running risks of this order in subscribing capital to the company.

Synchronising the Tipping Sheets with Selected Mining's Dealings

Although the share dealing undertaken on behalf of Selected Mining Holdings was soon to lose the shareholders of that company a large amount of money, in the early days of trading some profits were realised. A detailed examination of this early trading, as well as later dealings, by the two discretionary accounts run by Patrick Partners, revealed a degree of synchronisation between the purchases in these accounts and the tips circulated by A.I.C. that was similar to the co-ordination already noted between A.I.C.'s own trading and the tipping sheets. The timing of Selected Mining's joining the share market casino with a cash fund of nearly $2 million may also have been especially heralded for those who knew of A.I.C.'s associations, by an A.I.C. circular. Following the first purchase of shares in what was named 'Patrick Partners - S.M.H. Trading A/C No. 1-Syd' on 24 September 1970, Investor's Guide on 30 September 1970, under the heading 'The Bulls Take Over', began with the comment: 'We are now prepared to go out on a limb. The mining market has entered a bull phase, and the momentum of the advance can now be expected to quicken ...'

Examples of A.I.C.'s tipping sheets pushing shares that had just been purchased in one or other of the two Sydney discretionary accounts are as follows:

Minerals Recovery

5,000 shares bought at prices between 33 cents and 35 cents a share, 25 September 1970.

Investor's Guide, 6 October 1970: 'We recommend this stock with confidence ...', 'Only listed one week - buy now'.

5,000 shares sold 12 October 1970 at 37 cents a share. Lamadec (first purchase) 14,500 shares bought at 30 cents a share, 30 September 1970.

Investograph, 2 October 1970: 'We recommend purchase at this price [32 cents] as this stock seems to be a runner. There are rumours of good prospects in the field for this company. A target is indicated at 46 cents in the short term'.

Investograph, 6 October 1970, when price 42 cents: '... a base is forming for a further upward move'.

14,500 shares sold at 43 cents, 6 October 1970.

Lamadec (second purchase)

131,000 shares bought between 12 October and 1 December at prices between 25 cents and 44 cents a share.

Investograph, 4 December 1970, when price 29 cents: 'Testing in depth is at an early stage but already the indications are that a good sized orebody can be delineated. On the basis of some very approximate calculations to date, it would appear that if the prospect continues to prove up, this stock could be worth between $2.00 and $3.00.'

Investor's Guide, 11 December 1970: 'subscribers should be looking for a strong volume increase with a break above 32 cents. This would be most bullish'.

Western Compass

5,000 shares bought at prices between $1.15 and $1.18 a share, 30 September 1970.

Investograph, 2 October 1970: 'This highly regarded new listing is still in a galloping uptrend. A further target is now indicated at $1.50 ...'

5,000 shares sold at 85 cents a share, 21 October.

West Coast Holdings

13,900 shares bought at prices between $1.75 and $1.80 a share, 1 October 1970.

Investograph, 9 October, when price $2.45: '... the focus of traders' attention throughout the week ... recommend they [subscribers] look for a position in the stock in the near future ... it is obvious that if the areas to be exposed really have potential there is scope yet for a much higher market capitalisation for the stock in the short term.'

Additional 3,500 shares bought at prices between $2.80 and $2.85 a share, 12 October.

Investor's Guide, 13 October: '... there is a target at about $3.75 and as the scrip position must be becoming extremely 'tight', this projection could be met very quickly.'

17,400 shares sold 14 and 21 October at prices of $2.60 and $2.42 a share.

Hill Minerals

10,000 shares bought at prices between 78 cents and 80 cents a share, 1 October.

Investograph, 2 October: 'A very strong uptrend here. A target is indicated at 98 cents. The present price is an ideal buy point and a further upward move in the short term seems likely.'

Investograph, 9 October: '... the price ~6 cent~ looks poised to move upward again at any time.'

10,000 shares sold 16 and 19 October at prices between 93 cents and $1.00 a share.

Selcast

8,800 bought 26 November at about $1.60 a share.

Investor's Guide, 27 November: 'The market action of the stock suggests that there are good grounds for believing that, by and large, informed investors are prepared to support Selcast at around $1.50, and we would recommend it with reasonable confidence at the moment despite market conditions. Any overall rally in this market would certainly carry Selcast to around the $2.00 level as suggested by the technical appraisal.'

Investograph, 27 November, also recommended the share 'for medium term accumulation.'

Sales: 8 December, 1,700 at $1.85; 16 December, 600 at $1.55; 10 February 1971, 3,800 at 80 cents.

This pattern of A.I.C. tips following certain purchases made for the discretionary accounts of Selected Mining had been established when, in mid-December 1970, Selected Mining's directors sanctioned an especially large allocation of the company's cash for share-trading purposes. On 16 December 1970, these directors met with a partner of Patrick Partners and approved a purchase of shares in Castlereagh Securities Limited to the value of $100,000. Approval was also given for A.I.C. to buy shares in this company on behalf of Selected Mining up to a cost of $500,000, subject to approval of the directors being obtained for each commitment of $100,000 (Committee Document 7-10~

With these decisions, Selected Mining was linked even mere firmly with its broker-underwriter, for the senior partner of Patrick Partners, Mr Dowling, was a director of Castlereagh, and Patrick Partners had been a sponsor of that company's recent flotation, and was acting as its financial and investment adviser. The Castlereagh prospectus had said that 'In matters of financial and investment control, it is intended that the company should draw upon the advice and initiative of Patrick & Company [Patrick Partners].' Patrick Partners also managed $1 million of Castlereagh's funds in a discretionary share-trading account (Ev. 1992) and, through their associated investment and share-trading company, Patrick Corporation Limited, had a large shareholding in Castlereagh.

This latest movement of Selected Mining's funds into the share market was also co-ordinated with A.I.C.'s customary devices for attempting to influence upwards the price of shares that had just been bought by the company it was ostensibly managing. Immediately following the purchase of 286,000 Castlereagh shares on 15 and 16 December 1970, A.I.C. published an issue of Investograph on 18 December in which the Castlereagh company was specially reviewed and its shares strongly recommended. The same favourable review appeared in A.I.C.'s other market news-sheet, Investor's Guide, which also appeared on 18 December. In the 'technical appraisal' A.I.C. said:

... the volume characteristics in our bar chart of this stock are most encouraging and suggest an upward break out would be possible at almost any time now.

About six weeks later Major Douglas prepared a special report on Selected Mining's share trading (Committee Document 7-11), and in this he gave a reason for Selected Mining's large purchase of Castlereagh shares which was not expressed in his tipping circulars:

Castlereagh - quantity 286,000.

These shares were purchased under the strongest possible encouragement of the Patrick mining advisor and the Patrick investment advisor who, just before Christmas 1970, claimed that this stock would probably go up about 50 per cent within the next two weeks and would double within the next five or six months. The purchase had Board approval.

It is not possible now to determine reliably all the steps that were involved in Selected Mining's directors and advisers countenancing a $500,000 purchase of Castlereagh shares, but it is clear that, by December 1970, share trading undertaken on Selected Mining's behalf by Patricks and A.I.C. was being combined with the share-tipping and rumour-spreading network based upon A.I.C.

The $376,000 Interest in Mining Claims

Although the primary purpose behind the flotation of Selected Mining was to gather together a large volume of public funds for speculation on the stock market, in December 1970, Selected Mining did come to acquire an interest in a group of mining claims. The evidence suggests, however, that the move was contrived more as part of a scheme to avoid Selected Mining's funds falling into the hands of another group than it was to carry out mineral exploration.

Following Press comment (on 9 December) about a possible market 'raid' on the shares of Selected Mining Holdings, Mr J.H.S. Wills, a director of a Sydney company, Devex Limited, telephoned Major Douglas on 10 December to say that Devex had acquired 24 per cent of Selected Mining's shares and 10 per cent of the options (Ev. 2585). The next day Major Douglas was told by the same director at a meeting in Melbourne that Devex wished to obtain control of Selected Mining's board. On Monday, 14 December, Major Douglas, accompanied by another Selected Mining director and a member of A.I.C.'s staff, visited the Sydney office of Patrick Partners for discussions with two of the partners of that firm about Selected Mining's affairs. While he was at the broker's office, Major Douglas was informed by a representative of Devex that that company had increased its holdings to 32 per cent of Selected Mining's shares and 18 per cent of the options. The following day, Devex wrote to Selected Mining setting out the details of these holdings and asking for the reconstitution of the Selected Mining board to allow Devex to nominate three of the five directors. These events were recorded in the minutes of a meeting of Selected Mining directors on 16 December, at which a representative of Patrick Partners was present (Committee Document 7-10).

It was agreed 'in principle' at this meeting that Selected Mining would purchase an 80 per cent interest in mineral claims held by Patrick Corporation, the investment and share-trading company closely affiliated with Patrick Partners, and that the purchase price would be settled by cash and a placement of shares at par with attaching options. It was also recorded that Mining Advisers Pty Limited (a partially owned subsidiary of Patrick Corporation) would be the 'manager for the prospects'. Two days later, the stock exchanges were told of this intention to place additional shares in order to acquire mineral prospects. On 23 December, the Selected Mining directors met, again with a partner of Patrick Partners in attendance, and formally approved of the mining venture with Patrick Corporation. The cost to Selected Mining of the 80 per cent interest in the mineral claims was $376,000, an amount settled by the cash payment of $176,000 and the issue of one million fully paid 20-cent shares which carried the rights to 500,000 options. The person who signed the 'Memorandum of Agreement' setting out these details on behalf of Patrick Corporation was Mr N.R. Course, who was a director of Patrick Corporation as well as a partner of Patrick Partners in the Melbourne office (Committee Document 7-12). The Selected Mining shares and options were acquired by Patrick Corporation, and the remaining 20 per cent interest in the mining claims was retained by that company too. The immediate effect of this allotment of new Selected Mining shares (equal to ten per cent of the outstanding issued capital) was to dilute Devex's existing holding, thereby reducing its chances of acquiring control of Selected Mining, and the reaction of the Devex directors was to begin legal proceedings to try to have the issue set aside.

In his evidence, Major Douglas said that, after Selected Mining's flotation, he had tried unsuccessfully to interest Patrick Partners in arranging for Selected Mining a joint-venture in mineral exploration with another company connected with the broking firm. Subsequently, and coincidentally with the takeover attempt we have described, he had concluded the joint arrangement. Mr Douglas said that he had entered into this venture 'because [he] felt this was one of the things in the prospectus', and he added: 'I thought it would help the share price if [Selected Mining] got tied up with a strong company in this field rather than go it alone ...' His reply to a question as to why he had been interested in 'helping the share price of Selected Mining' was: 'It prevents the takeover of the company below asset value'. Mr Douglas also believed that a higher share price would have assisted the Selected Mining shareholders in trading in their shares; and he thought that this would have been the objective of 'all' shareholders at that time. He said that the reason the firm of Patrick Partners was asked to arrange a joint venture was 'because I believed that they were the best people to go in with and they had an arm - I just used the word "arm" - they had mining advisers who had the geological ability to carry out the work'. Major Douglas explained that within Selected Mining there was a 'lack of knowledge in the field [of exploration]', and subsequently he added that he did not 'believe a company such as Selected Mining should go into that sort of area unless it goes into a joint venture with people with that expertise' (in camera).

Several comments may be made on this evidence. First, the arrangement of the joint venture seems to have been viewed by

Major Douglas more as a means of countering a bid by another company for control of Selected Mining than as a genuine attempt to explore for minerals. From Devex's viewpoint~ the agreement with Patrick Corporation did substantially weaken its prospects of gaining control. Also, Mr Wills (a director of Devex) drew the inference from a conversation with Mr N.R. Course in Melbourne, that Patrick Partners and Patrick Corporation were prepared to support the existing directors of Selected Mining (Ev. 2587). (During January 1971 Devex decided not to proceed with its attempt to acquire control of Selected Mining, and all its shares were sold to another company, (see Chapter 12). Our second comment is to draw attention to the difference between Major Douglas' views on the company's ability to carry out mining activities and the statements which had been made in the prospectus about the directors' intentions in respect of exploration and mining. The prospectus had stressed the directors' enthusiasm for the future prospects of the Australian mineral industry; it spoke of exploration expenditure bringing 'to light a steady stream of new discoveries' providing 'an almost unlimited field of opportunities for investment'. Specifically, the directors were going to see that the company engaged 'in mining activities on its own account or in association with other companies' and would form 'mining or oil companies'. Yet, according to Mr Douglas, who was chairman and manager of the company, he and his directors had a 'lack of knowledge' of exploration, and he did not believe a company such as Selected Mining should undertake exploration alone. Public investors were not given this additional information, with the result that the prospectus' statements were at best half-truths.

After agreeing to this acquisition of an interest in mineral claims, the directors remained in office for only about a month, and they bear no responsibility for the board decisions made under the chairmanship of Dr M.D. Garretty after 27 January 1971. However, from the point of view of Selected Mining's shareholders, this venture by the first directors turned out to be as costly as some of their share gambles. Neither the original directors nor their subsequent replacements chose to spend any money in exploring the claims that had cost $376,000, and the report to shareholders dated 30 June 1971 simply said 'Investigatory work is yet to be carried out to ascertain their value'. Some months later the company was seeking to rescind the agreement of December 1970. Although, aS we have seen, the flotation prospectus had indicated that the company would be using part of its funds for exploring, in the eight months to June 1971 no money was spent on this activity. Moreover, by that time it was probably too late to begin, for as we show in Chapter 12, at 30 June 1971, of the $2 million that had been raised, less than $300,000 was left.

A Broker's Arm

We have said that when Major Douglas, as chairman of Selected Mining Holdings, sought to acquire for the company an interest in mining and mineral exploration, he turned to Patrick Partners in the knowledge that this broking firm had an 'arm' extending into these other activities. Something may now be briefly said about the nature of this 'arm' of the broker, first in order to show how it came to be available to assist Selected Mining Holdings, and secondly to note in passing two other occasions, not connected with A.I.C., when it was brought into use. This illustrates how wide-ranging the interests of stockbrokers can be in the securities markets, providing something of a mirror-image to the numerous ramifications of some investment counsellors.

The broker's 'arm' was, in this instance, the associate company, Mining Advisers Pty Ltd, which was one of a group of companies closely affiliated with Patrick Partners and for which the broking firm acted as the banker (Ev. 2665). In discussion with Mr Dowling of Patrick Partners, who was a director of Mining Advisers~ we were told that within the Patrick group of companies, Mining Advisers acted as 'a mining service company' (Ev. 1975).

In reply to our question of whether the role was 'complementary in some way to the other business of other sections of the group' Mr Dowling replied: 'No. I think purely as an arm - a long arm admittedly - a long way off'. In elaborating on this description he agreed that 'it was an integrated arm, in that it was intended that it should play a part in the overall activities of the whole group'. He said: 'Western Australia was very active in exploration. It seemed a good idea to have a small organisation in the midst of that exploration' (Ev. 1979).

Up until 30 June 1971, Mining Advisers had spent $1,997,390 on exploration, pegging and the acquisition of mining claims and titles on behalf of companies within the Patrick group, and of this amount $236,541 was spent on options over claims; $414,016 on pegging costs and claim rentals, and $1,346,833 on exploration and administration expenses (Ev. 2272). Mr Dowling said that the options and mining titles were bought from prospectors, companies and other vendors, and that 'a great number' were also sold (Ev.1976). He thought that there had been 'hundreds of companies' in this business of buying and selling leases (Ev. 1976), and that Mining Advisers' method of getting in touch with the vendors and purchasers was by having 'thirteen or fourteen geologists in the field who would have had a lot of contacts' (Ev. 2273).

Mining Advisers not only pegged, purchased and sold claims for its associates within the Patrick group of companies, but carried out these activities and provided geological advice for clients of the Patrick group as well as for other interested parties (Ev. 1977 & 1979-80). In the case already mentioned, Selected Mining was a client of Patrick Partners, the stock-broking 'arm' of the Patrick group, when Mining Advisers gathered together the claims for Selected Mining's venture into exploration. In this instance Mining Advisers was also appointed manager of the project. Another example of Mining Advisers doing work for a client of the broking firm was in the flotation of Australian Antimony Corporation N.L., in 1969. The Patrick broking firm was the underwriter of the issue (one of the partners was also a director), and Mining Advisers was listed in the prospectus as one of the consulting geologists. An employee of Mining Advisers also signed one of the 'Consulting Geologist's Reports' in the prospectus. The services of Mining Advisers were used in a rather different way in the flotation of Mogul Mining N.L. in 1970, for on that occasion Mining Advisers, in association with another member of the Patrick group, MTB Pty Ltd, gathered together a group of mining titles for the Mogul company that was then floated through Patrick Partners (Ev. 1977-78).

Elsewhere in this Report we discuss in more detail the Patrick broking firm and its associated group of companies, but at this stage we conclude, from the evidence relating to A.I.C., that the ramifications of stockbrokers can be no less wide and various than those of the investment consultants who may have dealings and associations with such brokers.

Concluding Comments

The Committee does not know what losses were suffered by those who acted on the ill-based rumours and tips circulated by A.I.C. Nor, with some exceptions (see Chapter 9), do we know the extent to which people and companies made profits from the runs forecast or promoted by A.I.C. Nevertheless, in our view, it is not necessary to quantify such profits and losses in order to conclude that A.I.C. was irresponsible in spreading tips and rumours without taking reasonable steps to check their validity. Moreover, the company abandoned reasonable standards of fairness in its dealings with the public when it repeatedly and knowingly misled them in its circulars and advertisements upon the sources of its information.

Tips and rumours were openly disseminated through innumerable conversations mainly with local and overseas brokers, hundreds of editions of A.I.C. tipping sheets and market circulars, and advertisements in the financial Press. When the Committee asked Major Douglas whether he thought he could have been used deliberately for the spreading of information that would induce buying pressure for a share that certain holders wished to sell at a high price, he said: 'I think that is so'. Major Douglas also said that he had heard of organised runs being started by people buying shares at increasing prices in order to have the rising turnover and prices commented upon by chartists who in turn encouraged the public to buy the shares at even higher prices. His reply to our question of whether he thought he had been used in that way was: 'I only hope to God I was not', and he went on to draw attention to the limited size of A.I.C.'s subscription list, which would restrict the extent to which he could influence the market (in camera).

In discussing the capacity of A.I.C.'s news-sheets to influence prices, Mr Dowling of Patrick Partners also made the point that 'a small news-sheet has a very limited circulation, and unless it gets requoted it does not get wide publicity', and he added that 'it is the daily Press which has wide publicity'. He agreed, however, that the daily Press may be more likely to publish something if it has been published in some of the smaller news-sheets and started to get currency from that source, and he also said that his own firm summarised weekly 'every statement made in every financial journal or news-sheet' (Ev. 2308). In the case of A.I.C., as we have seen, through a television program, and an inbuilt relationship with a journalist writing a weekly article in a national paper on current rumours in the markets, the tips spread by the news-letters received a much wider circulation than that defined by A.I.C.'s list of clients. This extension of A.I.C.'s range of influence meant that the share rises predicted by A.I.C. were more likely to come about, thereby enhancing A.I.C.'s reputation as a tipster. Moreover, by acting as a 'clearing house' for rumours, A.I.C. probably gave the tips more credence than if sharebrokers and others had communicated the stories directly to each other. Major Douglas agreed with this suggestion, adding: 'I had never looked at it that way before. Perhaps naively ...' (in camera).

Without disclosing its interest, A.I.C. was also a frequent trader in the shares it was tipping in the news-sheets. In extenuation of this behaviour, Major Douglas said that the volume of A.I.C.'s share-trading profits was modest by some standards, the figure for 1969-70 being about $13,000, according to the company's accounts. However, the failure to uphold principles and standards of professional responsibility to the public is not extenuated by the claimed modesty of the profits. It does happen that Major Douglas regarded share trading as an adjunct to his main business, and his financial resources used for playing the market which he influenced were meagre, perhaps derisively so by some standards. But the movements in market share prices attempted and sometimes achieved by his methods and associations were just as serious as they would have been if his own dealings had been twenty or a hundred times as great. The size of A.I.C.'s profits is not a measure of the extent to which A.I.C.'s unfounded tips and rumours distorted the share market and resulted in a mal-distribution of financial resources; nor is it a measure of the losses A.I.C. may have led its readers to incur. What is relevant is the fact that it was possible to act in two roles at the same time, that is, as a tipster and a share trader, and to use the combination of those roles for personal interest, while acting irresponsibly to the public.

A striking feature of the evidence of this case-study is the way, in just over two years, a chartist with a capital of about $100 was able to publish two investment and tipping news-sheets for distribution to brokers and investors around Australia and overseas, engage in share trading through a subsidiary and two other names, manage share portfolios for clients, publicise his activities on television, build up an association with a financial journalist who ran a share market column in a Sydney-based national newspaper, and promote a $2 million public company, Selected Mining Holdings, of which he became chairman and manager (through a proprietary company) mainly to engage in share speculation. Investment consulting firms are clearly one type of organisation in the securities market which can spring up quickly and can rapidly spread their interest to carry out numerous activities, with many of them impinging in different ways on the share markets. They require special attention by the regulatory authorities, especially during periods of widespread public interest in the share market, and in monitoring their affairs the authorities should be concerned with the nature of the ownership of the organisation, the methods by which advice is given, the consultant's own dealings, the extent of the consultant's discretion to deal in securities with or for his clients, the basis of compensation, and the relationships between the consultant, his employees and the Press. Beginning in 1970, four of the States introduced a measure of regulation of investment advisers, by requiring their licensing and the licensing of their employees performing this function, but this regulation has not spelt out what, in the Committee's view, are adequate standards on the matters just mentioned. Nor is the quality of administration uniform or sufficient in our view.

A.I.C. was only one among several charting, tipping and consulting groups which mushroomed in the share boom and which published news-letters of doubtful intention. The notable feature of A.I.C.'s case, however, is that its growth was substantially dependent upon the support of stockbrokers, and in particular of one large, prominent Sydney-based firm which provided the initial capital for A.I.C.'s expansion. The relationship with the Patrick broking firm was built up in several ways, but it probably reached its most involved stage with the promotion, flotation and management of Selected Mining Holdings, just at the point when the boom was collapsing. We found it difficult to see who, for the first few months of Selected Mining's public life, had effective control of a substantial part of the $2 million raised from the public - the directors, the company's manager, A.I.C., or the broker-underwriter through its discretionary share-trading accounts and its apparent capacity to influence the board's and A.I.C.'s investment decisions. Again, too, A.I.C.'s share-tipping facilities were used to complement this new activity by 'pushing' the shares bought by Patricks for the public company.

Although the activities of A.I.C. were not directly within the jurisdiction of a stock exchange, this was an instance where members of a stock exchange must bear considerable responsibility for having fostered a group which indulged in so many questionable practices and which brought to the stock exchange market a company which was quite unsuitable for public financing. A further aspect of the relationship between A.I.C. and stockbrokers is examined in Chapter 9.

7.59

CHAPTER 8
RUNS, POOLS AND RUMOURS

Some Types of Manipulative Practices

Testimony given by witnesses with a close knowledge and experience of the share market, together with our own investigations has convinced the Committee that the deliberate manipulation of the market for listed shares on the organised exchanges has at times been widely practised in Australia. Although this manipulation has been known to prominent market traders, the practices have seldom been exposed publicly. They have not been effectively regulated.

At various times in the Committee's investigations when witnesses were giving evidence on the types of manipulative devices, they referred to 'pools', 'churning' in shares, and organised 'runs'. Though differences can be distinguished between these various practices, each of the three devices has features in common, and all are designed to stimulate artificially market turnover and share prices for the purpose of profiting, at the general public's expense, from the distortions inflicted on the market.

Taking pools first, we were informed how, during the years of the mineral share boom, these were organised by groups of usually four or more wealthy investors agreeing to subscribe up to, say, $100,000 each to establish a substantial pool of funds - the pool being managed by a broker or someone with a close knowledge of the market. The members of a pool agreed to the shares of a particular company being bought at the discretion of the manager, and then being sold successively from one member of the pool to another member through the broker in order to boost reported turnover and price, so long as the total outstanding commitment of each member did not exceed the $100,000. The objective of the pool was to raise the price of the shares and provide the opportunity for members of the pool to sell their shares at a profit. Pools of various kinds were one of the major abuses uncovered and severely criticised by the investigation into stock exchange practices by the United States Senate Committee on Banking and Currency in 1932, but it will be noted from the examples in that Committee's Report (1934) that the shares fed into the market after the pool manipulation had been got under way were often new shares obtained through the exercising of an option from the company itself. In this respect, the pools in the United States appear to have been different from the Australian variety of the late 1960s and early 1970s. However, in Chapter 11, where we discuss abuses and malpractices in the making of private placements, it will be seen how manipulative practices have been taking place in Australia that are fairly similar to the pools which were occurring on the New York Stock Exchange in the 1930s and which were the subject of special attention in the Securities Exchange Act, 1934.

A practice similar to that of a pool is churning, and we received evidence on how share traders operating in the Australian markets in recent years used this device. They first acquired a holding in a share and then proceeded to place both buying and selling orders for that share, usually at about the same price, or at slightly rising prices, in order to build up the turnover. The buying and selling following the initial purchase about balanced each other out, so that no great additional investment was required. These schemes apparently were usually carried out through several brokers, some of whom did not know that they were being used for the purpose of market manipulation.

When sales arising from the churning were reported to the stock exchanges, unsuspecting investors interpreted the statistics as reflecting genuine interest by the market, and were induced to buy the shares. As the process gathered way, both price and turnover increased further, thereby providing the opportunity for the organisers of this churning to sell the shares they had originally acquired at a profit.

An Australian~ockbroker with a substantial business testified in camera to the Committee that his firm had been used by an Australian share-trading group for such schemes. He said that chartists in particular had been taken in by churning practices and had recommended the shares being 'churned' when they had seen the rising turnover combined with rising prices:

I think the unsuspecting investor uses charts. The reason I think they do is that there are a lot of people chart happy in Australia or chartists and if [he] sees tremendous increasing activity with rising prices, this really delights him.

Mr T.A. Nestel, managing director of Mineral Securities Australia Ltd, also gave evidence on churning and its effects. He believed that churning had frequently been used to mislead some investment advisers (who based their recommendations on charts of turnover and prices) into thinking that there was a great deal of genuine buying in a share, so that they would then recommend that share to the readers of their investment newsletters.

Senator Georges: What about the one that is not genuine - the one that is created by a movement of shares backwards and forwards? How often do you feel this occurred on the market? How often was a run deliberately started by a false activity?

Mr Nestel: This often happened through the avid interpretation of charts. Some people would see volume going into a stock, others would follow in and they would build up their own volume. It may have emerged that the initial volume was meaningless. This is I think where I referred to a run that has no meaning. You find a lot of people in shares who wish to see them higher.

Senator Rae: Can you give us examples of that?

Mr Nestel: A recent one was a case like Sedimentary Uranium where turnover came in, shares went up and people joined in. Everything looked excellent but it turned out that there had been no drilling for uranium for weeks because South Australia was under water. The stories were there that good reports were coming. Some have been glaring ...

(in camera)

This evidence was given by Mr Nestel in May 1971.

The Committee was informed that, when churning shares during the mineral share boom, the organisers operated not only in Melbourne and Sydney, but also on other exchanges and, in particular, on the London market. Dealings were arranged directly through London brokers, as well as through their Australian branch offices.

Although investors other than brokers had to obtain Reserve Bank approval before they dealt directly in London in Australian shares, in practice large Australian share traders found no difficulty in continually flouting this requirement. They were able to do so partly because they were continually buying and selling and did not need to make a transfer of funds which would have brought the matter to the attention of the Reserve Bank.

Moreover, witnesses testified that wealthy Australian investors wanting to obtain overseas currency in exchange for Australian funds did so through a well-organised system. We heard evidence of Australian residents depositing Australian funds in solicitors' trust accounts where they were held to the order of an overseas investor who wanted to hold funds in Australia. Balancing this transaction was the payment of overseas currency to the credit (usually of a nominee company) of the Australian resident in the bank account in some place such as Hong Kong, Switzerland or Nassau. The country chosen was usually one in which taxation was low, and in which it was difficult or impossible to trace the beneficial owners of the funds. In one particular case, an attempt was made by the Committee to trace the beneficial owners of companies in Hong Kong and Switzerland. We had received evidence that an Australian resident was probably a large owner of shares in the companies, and was using them to carry out large dealings in the securities of an Australian listed company of which he was a director. In both instances our inquiries failed to reveal who were the ultimate owners of the overseas companies.

Once an Australian resident obtained overseas funds, he was able to use them for dealing in Australian securities either in London or Australia. Sometimes the funds were remitted to Australia under the name of the overseas nominee or company and were used to play the Australian market. In some instances these funds were subsequently sent back overseas. Profits made on such dealings were also remitted with the original capital, usually without taxation payable on these profits in Australia.

Overseas markets and funds were used not only for organising pools and for churning shares, but also for organising what is known as a run on a share. Indeed most witnesses who discussed manipulative devices did not refer to pools or churning, but spoke of organised runs. These runs involved groups of people creating activity in a share either by their own buying or by the dissemination of rumours in order to bring about a sharp increase in prices of the shares. This in turn attracted further buyers and so higher prices. The purpose of attracting buyers into the market at rising prices was to enable the organisers of the run to sell their shares for a quick profit.

When one broker with a large Australian and international business was testifying (in camera) before the Committee, he was asked if he had heard of some investors using 'a very expensive communication system throughout Australia which indicates at the beginning of the day what is going to run that particular day'. He answered 'Yes', and explained that he had obtained this information from his clients at the firm's various branches. When asked if he had ever heard that a particular share was going to run at a certain time and subsequently noticed that it had in fact run, he replied: 'Yes, this is going on all the time'.

In discussing one particular broking firm of small to medium size which he knew quite well, the witness referred to the broker as '... a really hot salesman and he would get turnovers going on rumours. He has built up a business on this, but I have not heard of him paying for information'. Moreover, in the witness's experience London, too, was involved:

I think London is very bad, the way in which it has the special connections with people out here and arrangements to pay for information, sometimes to pay and sometimes I think that there are other arrangements, funds not coming to Australia.

Witnesses also spoke of brokers 'pushing' shares. 'Pushing' was described by one experienced investor as:

Ringing up people and saying that we think these shares should be bought or being a party to a rumour going around so that people are encouraged to make up their own mind or think that they are making up their own mind.

The object, again, was to bring about a run in that share.

Mineral Securities' Experience of Organised Runs

In addition to being managing director of Mineral Securities Australia Ltd (Minsec), Mr T.A. Nestel was the investment manager of the Minsec group of companies, and in that position he supervised what were evidently the largest share-trading activities that have ever been carried out by an Australian company. By any standards these dealings were huge. In the period of about two and a half years from July 1968 to 8 February 1971, when Minsec collapsed, Minsec's share purchases and sales totalled about $284 million. In individual stocks, Minsec's trading was enormous, making or breaking many runs. In testifying before the Committee, Mr Nestel gave evidence on the frequency with which brokers informed Mineral Securities about runs in particular shares:

Senator Rae: ... I want to ask you whether you were ever given knowledge that there may be a run in a particular share and whether that knowledge was given to you by a broker?

Mr Nestel: Yes.

Senator Rae: Could you give us any idea of the number of times that happened or the frequency with which that happened?

Mr Nestel: It happened on a lot of occasions.

(Ev. 1357)

This information was also made available to Mr Nestel in a personal capacity as well as to members of his staff:

Senator Rae: Could it be described as a regular feature of your life during the last couple of years with Mineral Securities that that type of information would be made available to you personally?

Mr Nestel: To me personally and also to other members of the investment department, yes.

(Ev. 1357)

Not all runs were deliberately inspired. In a market generally dominated by speculation, rumours causing a run can spread from numerous sources. Mr Nestel made it clear, however, that he was speaking of runs that were deliberately 'organised' and that he was advised when' ... they were about to take place, or were taking place, or were almost completed' (Ev. 1383).

Subsequently Mr Nestel explained the way in which he believed that brokers were involved:

Senator Rae: Did you understand that any Sydney or Melbourne brokers were involved in the organisation of runs; that is, personally involved in the organisation of them as opposed to being incidentally involved by passing on information which is a necessary part?

Mr Nestel: It would be more the fact that a certain broker was in a stock ...

(in camera)

Mr Nestel also told the Committee that, in his judgment, not only were there a large number of organised runs, but they were known to a large number of brokers, among whom were brokers from Western Australia, and these various brokers apparently informed him of the runs:

Senator Rae: I want to ask you further about the organised runs, whether you would give us an indication of the spread of information which you received. Did this come from a very limited number of broking firms or a wide spread of broking firms?

Mr Nestel: It came from a wide spread of broking firms.

Senator Rae: Were there any of them which were more frequent callers than others?

Mr Nestel: The ones that were more active in the mining market.

Senator Rae: Who were They?

Mr Nestel: One of the principal avenues came from Western Australia where there would be field information available: drilling would be starting in a week, or had started, or something in fact had been intersected. This would be coupled with chart prices and targets. Therefore the two would be combined with a view that stock A, subject to starting to drill within a fortnight, would reach a certain price. With this information widely disseminated in a good market, in fact, stock A would end up at the indicated price...

(<u>in camera</u>)

The Committee was told that those people who organised a run endeavoured to sell their shares to public investors who entered the market as purchasers in response to the rising turnover and prices.

Mr Nestel: ... the parties who got in early in the run would be selling out as the price was reaching the indicated level. This I found frequent ... the information would filter back from the West and presumably a lot of buying would take place in the West, subject to off-loading to the people in Sydney. This, I think, was one general avenue. A second avenue then would be where there would be a leakage of information that a certain assay, in fact, was good and based on this leakage it again was anticipated that the stock was worth a certain price. This then would be an organised run.

(<u>in camera</u>)

Mr Nestel said it has been his practice, after first hearing about a share which was expected to run, to make some assessment of the extent to which the rumour would be spread.

Mr Nestel: ... I was more concerned with the general atmosphere, if I could put it that way, ... they would nominate: 'Atherton Antimony will be making an announcement in a fortnight. It has a hill full of antimony. The stock will go to 80 cents'. I was concerned that if this information is spread widely enough, as I repeat, the stock will go to 80 cents.

Senator Rae: Irrespective of whether it is correct or not.

Mr Nestel: Irrespective of whether it is correct or not. In the right market sentiments it would go to 80 cents.

Senator Rae: So, if one knows what are the rumours which are being spread one can trade not on the accuracy or otherwise of the rumour but on the existence of the rumour.

Mr Nestel: Existence, in good markets ...

(in camera)

After considering these matters, Mr Nestel said he used to turn to a closer examination of the rumour and of the buying forces in the market. Given the size of Minsec's dealings in the market, and the influence Minsec's own buying could have on the run, it was apparently not difficult to discover what factors were causing the run. As Mr Nestel said: 'I must admit that they were always hopeful that Mineral Securities would join in the run - not always, but on a number of occasions - and we would find out why the run was on'.

It appears that it was not until these steps had been taken that Minsec's management began to examine the facts about the company's results and prospects. But if, inconveniently, the facts did not justify the price of the share~ it seems they tended to be ignored. Minsec was fundamentally a share trader, and knew better than most investors that a share price could rise for reasons other than what might be described as an improvement in the intrinsic merit of a company.

Mr Nestel: ... You would see the daily turnover rising and you would see a price movement, and at least this would be confirmation that a run, in fact, is under way. Invariably then one would get a reason as to why ... Then one did try to ascertain the facts, either from published information or from the many geologists one knew, as to what the validity was. But ... one of the worst things you could do in the hysterical days, if you like, was to talk to, say, a geologist about ... the share ... and he would tell you: 'It is worthless'. This was the other difficulty of judgment; that maybe at times you did not want to hear too much.

(in camera)

According to the evidence of Mr Nestel, Minsec also obtained inside information from geologists employed by listed companies, and the Perth office was used to collect and disseminate this information.

Senator Rae: Did you ever obtain information from geologists who had any special relationship with the mining company or mineral exploration company concerned?

Mr Nestel: Yes.

Senator Rae: Can you give us any idea of the frequency with which that happened?

Mr Nestel: I personally would have had little contact, but our geologists in the field or geologists anywhere would meet these other geologists and quite often there would be an exchange of what was happening.

Senator Rae: And that information would then be fed back to your company's head office for, shall I say, feeding into the system.

Mr Nestel: Yes.

Senator Rae: For assessment?

Mr Nestel: Yes.

(in camera)

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Mr Nestel: We also had a person permanently in Perth, and there would be an unlimited number of daily rumours coming through.

(in camera)

Mr Nestel, in the section of his testimony given in camera, quoted a number of instances of alleged involvement of various companies and broking firms in runs. After the intervals of time which had elapsed since the alleged instances, it was beyond our resources to follow up this evidence with investigations on the scale of completeness which would be necessary. Occurrences of this type in the securities market are not easily subject to satisfactory investigation on a retrospective basis after the pervading climate of rumour has passed. A system of immediate spot-check inquiries, by a body having the powers and means to carry out instant investigations across State boundaries on selected occasions, would be needed to deal with such practices.

A quotation from Mr Nestel's testimony on the Tasminex 'run' serves to illustrate the way in which it is believed that rumours may be spread in the markets.

Mr Nestel: One of the classics was Tasminex. I do not know how organised the run was ... one got information from Kalgoorlie because some drillers were drunk in the hotel and saying that they had a major discovery and so on. We picked up some thousands of shares and then the word quickly came across from the West and others bought in. The charts would have looked good and the end result is that with the further dissemination of this information the run started. That one got completely out of hand. As you know we made $1 million. I do not boast about that because presumably some people lost $1 million...

(in camera)

Mr Nestel explained how the firm of brokers through whom Minsec bought the Tasminex shares was also well informed 'on that particular situation because they also knew the drillers who were drunk or supposedly drunk'.

Mr Nestel: ... I do not even know to this day whether they were drunk but it was sufficient to start it. No one really anticipated Mr Singline would do what he did. We anticipated a modest profit of $5 [a share]. But this is the situation when you have a good pipeline from the West ... Most of it came across from the West. There were ones that we came out of badly. There was Westralian Nickel at about the time of Poseidon. Westralian Nickel was magnificently organised and we were buying vendor shares and any shares, presumably. As you know there is nothing there ...

(in camera)

Mr Nestel described the workings of the 'pipeline' from Perth to Sydney:

Mr Nestel: There are two sorts of pipelines, if you like, from official sources. One is if you have an agent or a broker in Western Australia. Naturally he can hear what goes on all day. The second one is investment consultants. We know that they are bold and very straight-forward people. They used to fly over everyone's property and issue a special monthly digest which we also received. I know that three or four brokers in Sydney also receive this.

Senator Rae: We have that.

Mr Nestel: If one knew that drilling was to start shortly and [the investment consultant] said that it had a good opportunity of finding nickel, this was sufficient for those brokers ... You would then start buying. They are all the ingredients that you needed for a genuine run. Some runs we presume were not based on anything.

(in camera)

While Mr Nestel testified that he did not know of speculators or others having access to official assay results before they were released to the companies concerned, he did know of unofficial assaying being carried out.

Senator Rae: Do you know anything at all of the circulation of rumours as to the supposed results of that type of assay?

Mr Nestel: Yes.

Senator Rae: That is, an assay done unofficially - deceptively - by and through a geologist or a driller?

Mr Nestel: We were getting information from the West ... There is a special chemical process now to ascertain from the gossan as to the chance you had of finding nickel. This in fact is being done ... This obviously must be done for our people to have got the information in Perth.

Senator Rae: The other part about which I wanted to know whether you had heard was as to whether special assaying is taking place locally. If I remember correctly, although I have not got the information in front of me, it was at Kalgoorlie. I am not certain about that, but it was somewhere within that area.

Mr Nestel: It could have been. I was going to say the second one is, it is often just an untruth that people, again from the West, seemed to know factually that a certain assay is so much. Sometimes it is true, which makes you feel therefore, that there must be some leakage of information. I realise often it is not true.

Senator Rae: But you would regard it as happening too often to be a pure coincidence?

Mr Nestel: Yes.

(in camera)

In addition to the formal testimony of witnesses, the Committee has received other evidence of a specific and confidential character which leads to the conclusion that the 'run' type of manipulation has been practised to an appreciable extent in recent years. Nevertheless, we cannot point to any successful prosecutions of individuals concerned in these practices, and the rare attempts which have been made to initiate legal proceedings in this area have been abortive. The Committee is aware that several cases of apparent manipulation of the markets have been referred to State authorities, but although periods of about three years have passed in each of these instances, nothing has been heard in public about what the authorities discovered, either in the form of a report on the specific dealings or in the form of a general statement on the kind of practices involved. It is also our impression that the silence in these cases does not at all conclusively indicate a negative finding on the question of the existence of the practices. There are, no doubt, serious difficulties in launching formal legal proceedings, again on a retrospective basis, in this area of conduct. This suggests that a more effective method of preventive treatment would be by means of a regulatory body designed to monitor and control current events.

CHAPTER 9
A CASE OF CONFLICTING ASSOCIATIONS IN A RUN

In the previous chapter we have described how three types of market practices - pools, churns and runs - have occurred in the Australian share market. In this chapter we present evidence to suggest how the multiple roles and associations of sharebroking firms may, in the context of a market 'run' developing in a stock, place the firms in an exceedingly delicate, and in fact, logically untenable position.

The full implications of the case which is to be described were established by the Committee in stages after it had received testimony in October 1971, from the senior partner of the prominent stockbroking firm of Patrick Partners. Part of the illustrative value of the example derives from the considerable strength which this firm happened to have as a force in the market.

In the course of receiving evidence on various aspects of the stockbroking firm's business associations, the Committee was, at its request, provided with the monthly share-trading schedules of a group of companies closely affiliated with the broker, and from one of these schedules it was observed that very substantial profits had been made from dealing in shares of the miner~ prospecting company, Barrier Exploration N.L., during a comparatively short period in the second half of 1969. Subsequently, our inquiries led us to find that an association existed between this broking firm and the Melbourne private company, Australian Investment Counsellors Pty Ltd. This association, which was mostly unknown to the general public, has already been described in Chapter 7. Finally, we became aware of complications arising from the association when we observed the circumstances in which Australian Investment Counsellors had been actively engaged in promoting a market 'run' in the stock Barrier Exploration while the Patrick broking firm was heavily selling the stock at transiently high prices for an affiliated share-trading company. It is now proposed to describe the circumstances in some detail.

Tipping the Run

As we have already reported, Australian Investment Counsellors Pty Ltd (A.I.C.) was a Melbourne firm of investment consultants which, during the boom in recent years in mineral exploration shares, had close associations with stockbrokers in preparing and commenting upon the charts of numerous stocks, and in the obtaining and dissemination of tips and rumours. These tips were frequently passed on to the public through two market circulars which A.I.C. published, called Investor's Guide and Investogarph, and many market tips on Barrier Exploration shares during the boom years were to be found in these tipping sheets. AIC itself claimed special recognition for its tipping of the run in Barrier shares in October 1969.

Through 1968 and 1969, AIC commented upon Barrier shares quite frequently; in September 1968, for example, they were recommended in the following way:

The shares are in a minor reaction after the first run up to $1.22 and in due course should run again.

On 12 June 1969, Investograph informed its readers that Barrier 'is unlikely to run up for a while now'. About a month later, however, AIC had changed its mind, and the circumstances in which this change occurred provide an example of the interrelationship between the use made of charts and the circulation of rumours and tips.

During the first week of July 1969, Barrier's share price rose from about 45 cents to about 60 cents. A favourable rumour about the company's prospects was apparently circulating, and under a heading 'New Nickel Prospect', a story was published in the 'Fossicking' column of the Australian on 9 July 1969 which reported that drilling was soon to begin:

With the smaller nickel explorers currently in the news, Barrier Exploration N.L. is likely to come under scrutiny soon ...

It is understood that a lot of work has since been done in the area [Cowan West] and four or five anomalies have been outlined. Work is said to be under way on these anomalies and drilling should start in about five weeks time.

Major B.G. Douglas, the chairman and managing director of AIC, had noticed on the chart of Barrier the appreciation in the share price of about 100 per cent in three weeks and, on 17 July, when the price was 72 cents, Investor's Guide published a story similar to that in the Australian's 'Fossicking' column, and strongly recommended the shares:

... We believe the company has outlined several anomalies at [Cowan West] and I.P. work on them is under way. <u>It seems likely that drilling will start within the next few weeks</u> ... Our field representative reports that the company is not only hopeful but extremely confident that good nickel values will be obtained by the diamond drilling. If good intersections are obtained we consider the share price will rocket up and could well clear the $2.00 level.

(AIC's underlining)

In answer to a question as to whether this was an example of 'market activity giving rise to a chartist's belief that confirmation of the rumour is available from the chart results', Major Douglas said: 'I would say that is a fair assessment. A chartist should look around to confirm what he sees in the market activity'. In addition, as has been pointed out in Chapter 7, there was an association between the author of the 'Fossicking' column and AIC and this may have led to AIC's publishing comments similar to those in the Australian.

As there was no public announcement at about this time giving the information contained in Investor's Guide, The Committee asked Major Douglas about his sources of information. He revealed that AIC did not in fact have a 'field representative' from whom the information was purported to have come. The expression, 'field representative', was, according to Major Douglas, 'probably a bit of poetic licence, but I did not mean it that way'. Major Douglas explained that normally the type of information such as was contained in Investor's Guide on 17 July 1969 was obtained from stockbrokers, but in this case the informant was a pilot who flew chartered aircraft. When asked if he knew for whom the pilot worked he said, 'I do not know really. Business Jets, I think'. (in camera)

During August and most of September, activity in the shares of Barrier was unexceptional. Moreover, the market generally was languishing. On 23 September, however, the company informed the stock exchanges that it had begun diamond drilling at its Cowan West nickel prospect, and this announcement was accompanied by an increase in share turnover and some rise in prices (see accompanying table). AIC's newsletters did not mention Barrier during August and September.

TABLE 9-1

TRANSACTIONS IN THE SHARES OF BARRIER EXPLORATION N.L., SEPTEMBER 1969

	Sydney Stock Exchange		Melbourne Stock Exchange	
	Number of shares sold	Prices (low-high)	Number of shares sold	Prices (low-high)
Week ended				
5 September	13,900	50-52c	10,700	51-53c
12 September	39,200	52-65c	13,500	55-65c
19 September	28,100	60-64c	12,600	60-67c
26 September	72,800	64-78c	52,900	60-77c

From the beginning of October, AIC began to tip a run in Barrier shares:

On 1 October: '... they could run up to $1.75. The company is drilling on the Cowan West Prospect'.

On 8 October: 'While the few fortunate or canny enough to hold Poseidon shares are counting their riches, the majority will be searching around for another stock that may have a chance of emulating its meteoric price rise. We have already recommended and many subscribers would no doubt have purchased, Barrier Exploration, which has run up from about 60c to $2.00 and we do feel that it could well reach $4.00 to $5.00.'

The sharp rise in the price of Barrier shares, so accurately predicted by AIC, caused the Sydney Stock Exchange to telex the Melbourne Exchange (Barrier Exploration's home exchange) on 8 October, pointing out the 'extremely significant rise in price ... a little out of the ordinary even considering present state of market'. Following an inquiry by the Melbourne Exchange, the chairman of Barrier Exploration replied publicly that he knew of no reason for the rise in price, and had nothing to add to the company's statement of 23 September 1969.

The 1969 Annual Report of Barrier Exploration was released on 10 October 1969, and this stated that during the year 'most assessment work was performed on the Cowan West Nickel prospect which has responded very encouragingly'. This report was referring to the work done in the period to 30 June 1969, and the company's statement of 23 September 1969 was the public notification that drilling had begun.

On 15 October, AIC once more drew its readers' attention to Barrier shares, predicting further increases in price:

After further consolidation between its present level of $2.30 and about $2.50 it would not surprise to see it continue its present advance.

Two days later the Perth Stock Exchange sent the following telex message to the Melbourne Exchange inquiring about rumours of a report by the company:

Rumours Ha Ha here have report issued your exchange can you supply any details if this is so.

The Melbourne Exchange immediately replied that it had had no report since the chairman's statement of 8 October.

AIC's particular interest in runs was the feature of the company's advisory service which was specially emphasised in its advertisements in the financial Press during October 1969. For example, its large advertisement in the Australian Financial Review on 2 October 1969 began with the bold headlines:

SURGE IN SELECTED MINING SHARES FORECAST

and followed this with:

Prepare to profit with expert AIC predictions ooo Not all stocks will run - you can pick the one that will by reading 'AIC Investor's Guide'.

While the turnover in Barrier shares was rising fast, accompanied by higher prices, AIC again, on 14 October 1969, inserted a large advertisement in the Australian Financial Review. Headlines on this occasion were:

A.I.C. SUBSCRIBERS ARE HAPPY

A.I.C. GUIDE dated 17/7/69 strongly recommended Barrier Exploration at 60 cents.

In the rest of this advertisement AIC quoted the tip purporting to come from the company's 'field representative', and went on to inform readers that AIC's latest 'special selection' was Norseman Gold. The Committee again inquired about the source of the information used by AIC in its advertisements and newsletters:

Senator Rae: In a significant number of editions of your publications recommendations are made for Barrier Exploration in respect of Norseman Gold, and you have information from your 'field representative' and other such expressions. You have a number of pieces of information which were not generally available to the market. Are you able to tell us from whom you obtained that information?

Major Douglas: I cannot specifically be sure but I would imagine I received basically the information from an adviser of Patricks.

(in camera)

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Senator Rae: And your best recollection is that you got your information in relation to those from Patrick Partners' advisers, that is, the advisers employed by Patrick Partners?

Major Douglas: I could be wrong, Mr Chairman; that is a long time ago.

Senator Rae: But these were quite important ones from the point of view of the information which was being given out to your subscribers and also important to you from the point of view of invest-merit because you did in fact take up some shares, did you not?

Major Douglas: Yes - not too many though. And I would say my subscribers made a lot of money on those stocks.

(in camera)

Following this testimony from Major Douglas on 23 December 1971, the Committee obtained further documentary evidence, and Major Douglas finally appeared before the Committee on 16 June 1972. From these inquiries, we have established that, in addition to writing and circulating newsletters, AIC also acted as a promoter of a public company and manager of large investment funds, and that in these activities it had inbuilt associations with Patrick & Company. In a discussion about some of these connections with Mr M.R.L. Dowling, the senior partner of Patrick & Company, the Committee raised the question of the extent to which Patricks supplied AIC with information about rumours in the market. Mr Dowling said that he did not think Brian Douglas' firm received information that was not available to any other client, and that, in his view, 'the key' to the dissemination of information was to 'tell any client who rang up' (Ev. 2308). Subsequently the Committee referred Mr Douglas' statements about the sources of his information on Barrier to Mr Dowling, but he said he had no comment to make (Ev. 2735).

Weekly turnover figures and the range of prices of Barrier shares (paid to 30 cents) during October 1969 are set out in Table 9-2.

TABLE 9-2

TRANSACTIONS IN THE SHARES OF BARRIER EXPLORATION N.L., OCTOBER 1969

	Sydney Stock Exchange		Melbourne Stock Exchange	
	Number of shares sold	Prices (low-high)	Number of shares sold	Prices (low-high)
Week ended				
3 October	307,100	.75-$1.40	200,100	.75-$1.50
10 October	568,500	$1.30-$3.20	476,800	$1.50-$3.20
17 October	275,950	$2.35-$3.20	294,200	$1.90-$2.70
24 October	109,450	$1.85-$2.50	164,800	$1.85-$2.60
31 October	62,800	$2.00-$2.55	160,450	$2.00-$2.50

This table shows that, during the period 1 October to 15 October, when AIC, through its circulars and press advertisements, was tipping an extraordinary speculative run in the price of Barrier shares, first from about 90 cents to $1.75, and then to between $4.00 and $5.00, the market price, on a massive increase in turnover, did, in fact, leap to over $3.00. During this period, as we have said, the company's chairman announced that he knew of no reason for the rise in price. The first public information from the company on its drilling results was made available in November, when shareholders were informed that there had been 'no intersections of ore-type sulphides' to date, but that there was a great deal more drilling to be done. The share price fell through November, and in the second week in December, while the Poseidon boom was continuing, the shares were selling for under 90 cents.

In an earlier chapter discussing AIC's various associations and activities, we have expressed our view on the company's practice of circulating ill-based rumours through its circulars and misleading investors on the source of its information. The case we have described here occurred during the period following Poseidon's nickel discovery, when rumours were rife and the market in nickel stocks was fluctuating wildly as it responded to many interrelated influences. Nevertheless, the evidence we have seen and heard suggests that AIC played a significant role in accentuating the Barrier run. Also, as we have pointed out, A.I.C. was itself, at the time, anxious to seek public recognition of its 'prediction' of the run in order to build up its list of subscribers to its tipping sheets.

The Dealings of Mining Traders Limited

Mr Dowling of the Patrick stockbroking firm told the Committee, in the course of giving general evidence on share market affairs in October 1971, that in his experience stocks did 'run' in the boom, often on the basis of rumours. 'There was a tremendous amount of turnover based on rumour in the market', Mr Dowling said. He also thought that 'many people have tried to start rumours, and some successfully', though he said he could not be sure about the extent of the organisation of these runs (Ev. 2303).

The firm of Patricks, besides being itself a trader, was closely involved in the ownership, direction and management of a group of share-trading and investment companies, among which the company Patrick Corporation Limited played a prominent role. Mr Dowling was also the chairman of Patrick Corporation. He told the Committee that 'probably personally' he would think of the share-broking firm and this associated company, together with the various interests of the company, 'very much as an entity; but of course, legally it is very much a separate entity'. He also explained that the partners of the sharebroking firm 'do not control the board' of the associated company, 'though we do have what might be termed practical control' (Ev. 1460).

One of the ways in which these share-trading and investment companies associated with the sharebroking firm operated during the period of the Committee's investigation, was by taking advantage of runs in listed shares.

Senator Rae: Did Patrick Corporation and its subsidiary companies take advantage of the runs? I am not asking whether they participated in organising. I want to make that quite clear. The question is: Did they take advantage of runs on the market? I presume any trader would.

Mr Dowling: Yes. If you think a stock is going to bring out a good report or if there is a good quality rumour around perhaps that seems to check out quite well, you might buy stock as a trader. I think the main rule is that if the rumour is wrong you sell it the next day or the day after; you do not hang on to it and hope.

(Ev. 2303)

A dramatic example of Patrick Corporation taking advantage of a run occurred in the case of the run in Barrier Exploration shares during October 1969 when, as described, the price rose from about 75 cents to over $3 within two weeks. In this instance the Patrick associate did not buy shares as a trader during the run, and then sell them, but concentrated on selling from a large holding acquired well before this run began. As Patrick Corporation was known as Mining Traders Ltd at the time of the run (it changed its name during 1970), that is the name we use in the rest of this chapter. We also refer to the Patrick broking firm as Patrick & Company, the name it had until 1970.

Mining Trader's share-trading portfolio became a very large holder of Barrier Exploration shares and options in February 1968, when the two largest shareholders in the company, Metals Exploration N.L. and the Freeport Sulphur Company, sold their entire holdings of 625,000 shares and one million options. A public announcement by Metals Exploration said that all these shares had been bought by Mining Traders. We found, however, that all the shares and options were sold to Patrick & Company as principals and the broking firm had sold to Mining Traders only 250,000 of the shares and 830,000 of the options. Some of the remaining shares were sold on the market by Patrick & Company, and the balance of the shares and options were sold to a group of other purchasers. A series of public announcements by Barrier, never subsequently corrected, then continued to say that Mining Traders held all the options, which it was exercising from time to time. We refer to the announcements concerning the sale of the Barrier securities by Metals Exploration and Freeport as examples of misleading reports to the exchanges which, in the course of our inquiries, became commonplace (see Ev. 2732-34).

After the large initial purchase in 1968 of 250,000 Barrier shares and 830,000 options (all exercisable before October 1969), Mining Traders exercised the options from time to time and traded profitably in the shares through 1967-68 and 1968-69. The last options were exercised in March 1969 and, at the beginning of July 1969, Mining Traders' share-trading portfolio included 546,100 shares paid to 30 cents and 240,000 shares paid to 10 cents. The sale of all these shares, as well as an additional 151,900 shares acquired in another cash issue to shareholders (underwritten by Patrick & Company), took place through Patrick & Company during the financial year 1969-70.

In July 1969 a total of 92,100 shares (paid to 30 cents each) were sold for a profit of $11,869 (see Table 9-3). Just over half of these sales took place during the week ending 18 July which, as already mentioned, was the week in which AIC published its Investor's Guide tipping that drilling was to start in the next few weeks and that their 'field representative' was 'extremely confident that good nickel values will be obtained'. These sales accounted for about 44 per cent of the total sales in Barrier shares (paid to 30 cents each) reported to the Melbourne and Sydney Stock Exchanges during that week. On other occasions during July 1969, Patrick & Company's sales of Barrier shares on behalf of Mining Traders also accounted for a substantial proportion of total stock exchange transactions in the shares.

TABLE 9-3
SHARE TRADING BY MINING TRADERS LTD IN BARRIER EXPLORATION N.L.

	Number of shares bought	Number of shares sold	Profit	Number of	Holdings at end of month Market shares	value
1969				$		$
July	30c paid shares		92,100	11,869	454,000	240,620
	10c paid shares				240,000	96,000
August	30c paid shares		52,300	3,673	401,700	200,850
	10c paid shares				240,000	86,400
September	30c paid shares		1,700	65	400,000	360,000
	10c paid shares		59,600	20,033	180,400	133,496
October	30c paid shares		365,500	731,604	34,500	74,175
	10c paid shares		62,800	58,400	117,600	199,920
November	30c paid shares				34,500	50,025
	10c paid shares		200	160	117,400	164,360
December	30c paid shares		14,500	7,592	20,000	28,000
	10c paid shares		5,800	3,106	111,600	108,252
1970						

January	30c paid shares		20,000	15,028	76,400	64,940
	10c paid shares		35,200	19,950		
February	30c paid shares				11,500	8,625
	10c paid shares		64,900	46,978	4,900	3,430
	10c new issue	151,900	147,000	103,134		
March	30c paid shares					
	10c paid shares		11,500	4,096		
	10c new issue		4,900	2,267		

For example, during the week ending 4 July, Mining Traders' sales were about 17 per cent of total sales, and during the week ending 25 July, the proportion was 30 per cent.

During August 1969, Mining Traders sold 52,300 Barrier shares (paid to 30 cents each) and these sales also accounted for a substantial proportion of the transactions in the shares reported by the main Australian stock exchanges. The proportion for the week ended 8 August was about 68 per cent; for the next week, 24 per cent; the third week, 29 per cent; and the last week, 56 per cent.

The largest volume of selling of Barrier shares by Mining Traders took place during October 1969, when 365,500 shares paid to 30 cents each and 62,800 shares paid to 10 cents were sold for a total profit of $790,004. During the first week of October, a relatively small number of the shares paid to 10 cents were sold. Then, beginning on Thursday 9 October, very large selling began of the shares paid to 30 cents, and between 9 and 15 October, 316,900 of these shares were sold in numerous transactions ranging in size from 100 shares to over 27,000 shares at prices mostly above $2.40 a share, with many sales at prices of $3.00 and above.

As already shown, over the five trading days between Thursday 9 October and Wednesday 15 October, the run signalled by AIC in its tipping sheets on I and 8 October, and in its advertisement in the Australian Financial Review on 14 October, was at its strongest. Most of the Mining Traders' profit of over $1 million from dealing in Barrier shares in the financial year 1969-70 came from the sales made during the five trading days between 9 and 15 October inclusive. In that short period, Mining Traders sold about 330,000 shares (including shares paid to 10 cents), equal to about 61 per cent of its holdings at the time. As a proportion of market turnover of the 30 cent shares in Sydney and Melbourne, Mining Traders' sales through Patrick & Company accounted for about 42 per cent on 9 October, 20 per cent on 10 October, 57 per cent on 15 October, 46 per cent on 14 October and 16 per cent on 15 October. During the whole of the month of October, Mining Traders' sales of the shares paid to 30 cents accounted for about 14 per cent of all transactions reported in these shares in Sydney and Melbourne.

Irreconcilable Conflicts

For many years in Australia the regulatory authorities have had evidence of brokers carrying out various activities which have, at times, compromised their integrity as independent advisers to, and agents for, the investing public, as well as their effective trusteeship for the public in running the country's share markets. The reason for the Committee's decision to pursue in detail the case-study set out in this chapter was to acquire at first hand a knowledge of particular types of associations involving stockbrokers, and to assess how effectively or ineffectively the stock exchanges and other authorities have been regulating these developments. As the Committee's inquiry progressively revealed AIC's role in promoting the October run in Barrier shares, the nature of the associations between Patrick & Company and AIC, and the way Mining Traders seized the short-lived opportunity for large-scale and highly profitable selling, we came increasingly to the view that the stockbroking firm concerned had placed itself in such an acutely critical position that it would be difficult to believe that it could still adequately fulfil its primary responsibility as a member of a stock exchange in offering the public objective investment advice. The following testimony from the principal of AIC, Major Douglas, refers to one aspect of such an association: namely, the possibility that an investment consultant may be used to fan or create a market run in order to provide an opportunity for the broker to sell a large holding of shares at a profit.

Senator Rae: ... In October, in your editions of 1st, 8th and 15th October, on each occasion you made encouraging comments about Barrier Exploration, and the share price by then went up to a maximum of something like $3.50 on the week ending October 24th. From the price of 42c in early July, going up to 70c in the latter part of July, in September they were still holding around that 60c or 70c, and then in October, at the time that you were each week tipping them, they went for quite a dramatic run up to $3.50.

Major Douglas: I am sure I did not cause that.

Senator Rae: I just wondered whether there was any coincidence in the fact that at the same time as you were apparently receiving encouraging information from Patricks, Patricks were also dealing in a gigantic way on the market in these shares.

Major Douglas: I would be very sorry to hear that.

Senator Rae: Why is that?

Major Douglas: Because I hope that I have never been party to anything of that type in my life.

Senator Rae: In that respect do you think it is possible, if you accept from me as a fact that they were dealing in a really massive way in the market, that you were being set up to assist?

Major Douglas: I would hope to heaven that I was not.

Senator Rae: Do you think it is possible?

Major Douglas: No, because I think I made most of the telephone calls.

Senator Rae: But you were a regular caller to them and there were daily discussions.

Major Douglas: Yes, I was a regular caller and there were daily discussions, I agree.

Senator Rae: So that it would only require it to be mentioned during daily discussions to encourage you to play your part, if in fact that is what happened.

Major Douglas: I have never had any evidence of this, Mr Chairman. Could I leave it at that?

Senator Little: Would you be surprised to learn that they were dealing in a massive way at that same time? In the information or the tips that they gave you did they indicate in any way that they were dealing in a massive way themselves?

Major Douglas: They would not do that.

Senator Little: Well, would you be surprised, then, to learn that they were?

Major Douglas: Yes.

(in camera)

In addition to throwing light on a disquieting aspect of associations between brokers and investment advisers who prepare and comment on charts and circulate tipster sheets, the Barrier run illustrates other problems facing broking firms which trade in shares. When Mr J.A. Keir appeared before the Committee in September 1972 as a partner of the Patrick broking firm, he was asked if his firm instructed its investment advisers to inform clients that the firm's associated company was trading heavily in Barrier shares at the time. He replied 'I am not aware of it' (Ev. 2661). The Committee then asked Mr Keir if the firm's investment advisers would have known of the selling by Mining Traders. Mr Keir's answers to this and succeeding questions were as follows:

Mr Keir: No, I would not be aware of that. I have no recollection of it - put it that way - at the moment. But, as I said previously, there was probably a reason for the decision to sell. That would probably have been based on information that would come from our research department, which would have been available to all investment advisers within the office.

Senator Little: Was any information given by advisers to clients not to buy at that time when the company sold?

Mr Keir: I do not know whether that would have happened.

Senator Little: You would not know whether that was done.

Mr Keir: The basis on which the decision was made would have been available, I would think, to all people, not necessarily ----

Senator Little: All clients would have had to ask specifically for it, rather than having it voluntarily passed along to them.

Mr Kelt: It would have been communicated where possible, I would think. We would not have put a circular out.

(Ev. 2662)

From this evidence the Committee concludes that during the main run in Barrier shares, most of Patrick & Company's clients were not specifically told, and therefore had no way of knowing, that the broking firm's associated company was a massive seller, accounting for a large proportion of the transactions reported by the stock exchanges. Moreover, not only was this associate a large seller during the run, but another share-trading company wholly owned by the partners of Patrick & Company, George C. Dummett Pty Ltd, was also a seller of the shares paid to 10 cents over the same period. Presumably the clients of Patrick & Company were not informed of this company's dealings either.

The Committee is not in a position to know what kinds of verbal evidence, if any, about the value of Barrier Exploration shares was given by members of the broking firm to its clients at the time when the firm and its associated companies were heavily selling those shares. There were many clients of Patricks who were sellers of Barrier shares during the run, and they would not have known to what extent their sales were being impeded or delayed by the s ales of Mining Traders Ltd or George C. Dummett Pty Ltd. There were also clients of Patricks who were buying Barrier shares, and they would not have been able to judge the extent to which Patrick's advice was coloured by the desire to effect sales for the firm's associated companies. Patricks effected most of Mining Traders' sales to London brokers, but the firm also sold some of Mining Traders' and George C. Dummett's shares to clients. Owing to the close association between Patrick & Company and Mining Traders - an association which led Mr Dowling to describe Mining Traders as 'an extension of' the broking firm, both organisations working 'in sympathy with each other' (Ev. 1460) - there was, .in this case, an inevitable clash between the interest of Patricks in selling Barrier shares for its associate and its duty in giving unbiased advice to clients.

Finally, it must be said that it was only by chance that the Committee uncovered the details surrounding the run in Barrier shares in October 1969 and the various ways in which one broking firm was involved in that run. There is no reason to believe that only one broking firm has allowed itself to become associated with chartists or share-tipping groups, and intertwined with share-trading companies. Thus the main lesson we draw from this investigation is not that one member firm of the Sydney Stock Exchange behaved in an unacceptable manner, given the context of its relationships and responsibilities, but that a lax and complacent method of self-regulation by the stock exchange has permitted brokers freely to develop multiple associations involving them in irreconcilable conflicts.

CHAPTER 10
ABUSES AND MALPRACTICES IN THE MAKING AND DISPOSAL OF PRIVATE ISSUES

Private Share Issues

Listed companies in Australia commonly use three methods of issuing new shares with the object of raising capital. These may be described as 'public issues', 'private issues' and 'rights issues'. In this chapter we examine some serious and widespread abuses of the share market facility by brokers and companies making private issues. A series of case studies which were mostly chosen at random for detailed examination will illustrate important principles relating to the maintenance of a fair securities market. The inquiry into these cases and the taking of evidence on them occupied a substantial part of the time of the Committee and its advisers during 1972. The case studies show a variety of practices which usually have the common effect of misleading the investing public and distorting the normal working of the markets in their role of financing capital formation. The specific cases are being reported so as to offer evidence of practices which are generally permitted to exist. It has not been our objective to single out particular firms and companies for discriminatory criticism, since we recognise that others also may be involved. At the conclusion of the studies, we draw some inferences regarding the present standards of regulation applied by the stock exchanges and State authorities.

Before beginning these case studies, however, we briefly summarise some of the requirements of the Companies Acts which determine the distinction between 'public issues' and 'private issues' and we follow that discussion with some general comments on the growth of private issues and the List Requirements of the Australian Associated Stock Exchanges which are relevant to the making of private issues.

Methods of Issuing Shares and the Prospectus Requirements of the Companies Acts

Public issues of new shares involve offers to the public of shares for subscription, or invitations to the public to make offers for shares. Where the element of an offer or invitation to the public is involved, the Companies Acts require registration of a prospectus in respect of the issue. The legal definition of an 'offer to the public' is uncertain in application but it is generally accepted that where the investing public is being asked to subscribe for shares in or lend money to a company, as distinct from, say, large financial institutions, then full disclosure through a prospectus is desirable.

Private issues of new shares, also commonly referred to as 'private placements', involve offers of the shares to a person or persons in a way that the shares cannot be said, as a matter of law, to be offered to the public. In such a case there is no requirement that a prospectus be registered with the appropriate State or Territory Commissions or Registrars. However, this is subject to an exception, discussed below, where a corporation issues shares to a person or persons 'with a view' to the shares being offered for sale to the public. In such an issue, section 43 of the uniform Companies Acts has the effect that any document by which the offer for sale is made is deemed to be a prospectus and must comply with the law on prospectuses and be registered. The section also provides that, unless the contrary is proved, it shall be evidence that an allotment or agreement to allot shares was made with a view to them being offered for sale to the public if it is shown that the offer to the public was made within six months after the allotment or agreement to allot, or that at the date when the public offer was made the whole consideration to be received for the shares by the issuing corporation had not been received.

Section 43 follows a provision in United Kingdom legislation which was mainly directed to the method of public issue known as an 'offer for sale'. This method, common in Britain, involves an issuing house taking up an issue and itself offering it to the public. That method of issue has not appeared to be common in Australia. But it seems prima facie undesirable that a company should be able to avoid the prospectus requirements by making an issue 'privately' to a few persons who themselves shortly thereafter, perhaps, offer the shares to the public. Section 43 has some relevance to this type of situation and hence to the practices revealed in this chapter.

Rights issues involve offers of shares to existing shareholders which may or may not be renounceable in favour of third persons. The usual practice in the securities market has been not to issue a registered prospectus for a rights issue, on the assumption that the Companies Acts do not require one. Some doubt has been cast on this assumption where the rights are renounceable in favour of third persons. In such issues the shares may in effect be offered to the public through the medium of the existing shareholders. The Company Law Advisory Committee in its Fifth Report to the Standing Committee of Attorneys-General has, consequently, taken the view that the law does and should require a prospectus in such rights issues, despite the practice to the contrary. But the practice has remained unaltered.

The three methods mentioned relate to new issues. As indicated in the discussion of section 43, once shares have been issued, shareholders in turn may wish to offer the previously allotted shares for sale, privately, to existing shareholders, or by an offer to the public. Questions of protecting investors in some such offers may arise. However, apart from situations falling within section 43 of the Companies Acts, and notwithstanding considerable doubts about the meaning of the legislation, it is the practice that a prospectus is not required to be registered where previously issued shares are offered to the public. Another section of the Companies Acts, section 374, does have the effect of requiring that a special statement accompany offers of previously issued shares to any member of the public in some circumstances. But there are important limitations on its application. Thus, it does not apply if the offer is to a person whose ordinary business it is to buy and sell shares as principal or agent (e.g. a broker) or if the offer is not in writing or by means of radio, television or film (e.g. if it is orally on a stock exchange floor), or if the shares to which the offer relates are of a class quoted on a prescribed stock exchange and the offer in writing so states and specifies and exchange. The following case studies highlight some aspects of the serious deficiencies of the present scheme of regulation of offers of shares both new and previously issued.

Private Placements: Their Growth and Some of Their Characteristics

The use of private placements as a means of capital raising has increased steadily over the past two decades in Australia. One factor accounting for this has been the growth of so-called 'institutional' investment in Australia. The typical institutional investors, the life offices, general insurance companies and pension funds, usually have a large flow of new funds available for investment, and since the mid-1950s they have been the major net domestic investing group in the share market. Before institutions became major purchasers of ordinary shares there were relatively few large pools of funds ready to be invested in ordinary shares. As the sizes of the individual pools of funds that could be tapped for share investment were much smaller, more of them had to be covered in order to raise a large amount of capital. A public issue or rights issue was then the appropriate method. Now, however, brokers and others seeking to raise funds for companies can often raise the amount required from a limited number of institutional sources in the form of a private issue. There is not the need to seek the funds of many thousands of families and other investors through the means of a public issue.

Usually, the shares in a private placement are issued at a price which is settled by negotiation between the company and its advisers (mostly including a broker), with the subscribers sometimes participating in these discussions as well. Generally the price is below the market price of the shares at the time, and sometimes well below that price. This difference between the issue price of the new shares and the market price of the shares already on issue has frequently provided subscribers to the new issue with an immediate 'stag' profit and this is an important reason why subscribers have often been readily available to buy shares being placed through private issues. On occasions the size of issues measured in terms of the amount raised has been large in relation to the company's share capital already on issue, on other occasions it has been small. Some private placements have involved cash sums of more than $5 million, others have been for less than a hundred thousand dollars. While many companies make private issues of shares in order to raise cash, this is not always so; shares are often issued privately in exchange for fixed assets, mineral prospects, or shares in another company which may or may not be a listed company. On occasions when two companies have made large private issues to each other (usually in order to avoid one or both of the companies being taken over by an outside group), the market value of the placements has been far in excess of $5 million.

Private issues are offered, commonly, through a broker or a merchant bank, and sometimes directly by the issuing company itself, to groups of individuals and institutions, including overseas residents, numbering from between two or three and several hundred investors. Some, or even all, of the subscribers may already be shareholders in the company. Typically the number of subscribers to a private issue is relatively small compared with the number that would generally subscribe to a public issue or be involved in a rights issue.

A factor encouraging resort to private placement rather than public issues has been the absence, mentioned above, of a Companies Act requirement that a prospectus be filed with respect to the former. The legal, accountancy, printing, administration and financial advisers' costs are usually lower for private issues than they are for a public issue of the same size. In addition, private issues generally provide advantages of greater informality and speed in raising share capital as and when it is needed and the capital market is favourable.

A number of general questions are raised by this growth in the phenomenon of private placements. One is raised by assertions that more issues should be offered more widely to the members of the public so as to increase opportunities for participation in ownership of equity in Australian companies. Some reference is made to this matter in another chapter of this Report. Another stems from assertions that more issues should be rights issues. One common complaint against private issues is that they dilute the equity of existing shareholders in their company. So long as the existing share capital is less than the authorised share capital, the directors will normally have power under the company's articles of association to issue further shares without seeking the approval of a general meeting. That position has been modified to some extent by listing requirements of the stock exchanges introduced during the life of this Committee. The relevant requirement was first announced in 1970 and introduced into section 3.H. (11) of the AoA.S.E. List Requirements in January 1971. The requirement was, briefly, that a listed company, in any financial year or within six months from its most recent allotment, not allot shares or grant options over its share capital exceeding ten per cent in nominal amount of the nominal amount of its issued capital without the approval of a General Meeting unless the issue be offered to all existing shareholders in proportion to their holdings, or be made pursuant to a takeover scheme in accordance with the Companies Act. The requirement has been altered in various ways by amendments effective on 1 March 1973. The most significant amendment is one aimed at preventing practices designed to avoid the spirit of the requirement by issues equal to, say, nine per cent of issued capital within short periods of each other. These limitations, however, have not been introduced as a check to the kinds of abuses described in the present chapter.

Private Placements and the List Requirements of the Stock Exchanges

It has been pointed out that private issues of new shares avoid the prospectus requirements so long as the issue is not made with a view to the shares being offered to the public. Nevertheless, if the company is listed there are obligations imposed on it by the List Requirements of the stock exchanges to inform the market of new issues by the company. It is essential to the establishment of a fair and informed market that shareholders be aware of such new issues for these may dilute the equity, alter the financial position of the company and affect the value of the company's shares in other ways. Consequently, section 3 of the A.A.S.E. List Requirements provides that, so long as companies remain on the Official List and retain official quotation of their securities, they are required to comply with certain requirements. The relevant requirements are to notify the exchange upon which the company's securities are quoted immediately of:

(1) Any information concerning the company or any subsidiary which, consistent with the interests of the company should be communicated to the Exchange for public announcement, including (inter alia) any information necessary to avoid the establishment of a false market in the company's securities.

and

(5) ...

(b) Any alteration of the issued share capital of the company, and particulars thereof.

Further, it is common for a listed company making a new, private issue to arrange for the quotation of those new shares on the exchange or exchanges on which the company is listed. Quotation gives the shares a readily ascertainable market value. Quotation also makes the shares more attractive to the subscriber by increasing their liquidity. In effect, the subscriber may ultimately be able to sell the shares to the public on the exchanges without a prospectus having been registered in respect of them.

If new shares of an already listed company are to be quoted and dealt with on the exchange~ established procedures for effecting quotation are laid down in section 2 of the A.A.S.E. List Requirements. The fact that shares of the same class previously issued by the listed company are already quoted certainly should not mean and, in our view, does not under the prevailing listing requirements mean, that new shares of the same class may be sold on the exchanges without their approval being given to quotation and the market being informed. Section 2 of the List Requirements has a statement of the prerequisites for the granting of official quotation of 'shares', not classes of shares, and it also has numerous detailed prerequisites for quotation of subsequent issues of shares by a listed company. For example, section 2.A.(4) provides that official quotation 'will only be granted to shares issued for cash after the Exchange is supplied with a statement setting out the amount paid by the allottees for such shares, including the premium (if any).' These requirements are referred to again in the course of this chapter.

The time taken in having these quotation arrangements completed, assuming the stock exchanges agree to quotation of the new shares, may extend from a few days to a month or more. This lack of immediate marketability is usually not of concern to recipients of the placement shares who are long-term investors, such as life offices and pension funds. But in any event, even if they do not have the force of law it must be obvious to anyone reasonably aware of the workings of a sound securities market that compliance with these requirements is an important matter.

Vam Limited Raises $676,600 through Ralph W. King & Yuill

During the years of the recent mineral industry boom there were relatively few companies that expanded at the rate of Vam Limited. It did so through the acquisition of new mineral titles, by promoting or partly-sponsoring new company flotations, and by raising large amounts of share capital on the stock exchanges. At one stage the company had about 24,000 shareholders, and there were about 1,500 employees within the Vam group of companies. Based on share market prices in April 1969, the enterprise was valued at about $35 million. Shareholders' funds at about that time were $9.2 million, but rose to $24.6 million in 1970. In October 1969 Vam's chairman, Mr Frank Archibald Close, in a 'Notice to Shareholders' advising them of an options issue to raise $4.5 million, revealed something of the spectacular growth of the group he had done so much to promote:

The company's role from that of simple prospector for natural resources has changed and the company has now become the pivot for numerous subsidiaries which look to Vam Ltd for management, technical know how and financing ...

In financing, Vam's role is similar to that of a merchant bank with large obligations for loans. For example commitments of $3,700,000 for VAMGAS N.L. and $2 million for Surveys and Mining Ltd, as well as equity holdings in these two companies. (The current market value of these shareholdings is $20 million).

In an earlier but similar announcement to the stock exchanges Vam had also disclosed that the underwriter of the $4.5 million option issue would be the firm of Ralph W. King & Yuill, a member of the Sydney Stock Exchange. Although it was not the first time this broking firm had agreed to assist Vam in raising large amounts of capital, it was, nevertheless, probably taken by many investors as an encouraging sign that a leading broker-underwriter was continuing to support the company.

At least as far as the public was aware, the company's prospects could scarcely have appeared better. The chairman had informed shareholders that Vam had 'operations pending in bauxite, salt, silica, blue metal and ilmenite' as well as 'highly prospective situations in copper ... in nickel ... and a vigorous sulphide search in Western Australia'. Shareholders were also told that 'the various directorates of the Vam Limited Group of Companies are represented by over twenty experienced people drawn from many walks of life' and that 'benefits ... will be derived in the near future, both from the capital appreciation of the Company's assets and the earnings which undoubtedly will accrue'. There was no hint of serious problems, let alone of financial difficulties of the kind that could have resulted in the appointment of a provisional liquidator in February 1971 and his subsequent announcement(on 6 October 1972) that between 30 June 1969 and 30 June 1971 the company had accumulated losses of about $23 million, reducing shareholders' funds to $1.49 million.

In order to raise some of the large amounts of capital needed to finance its expansion Vam made 'private' issues of new shares through stockbrokers. This Committee selected at random for examination only one of these placements. We found that this was an instance where the broker concerned, Ralph W. King & Yuill, and the company effectively made a new issue of Vam shares to the public through the stock exchange markets at prevailing market prices. This was accomplished by a series of acts the effect of which was to mislead the investing public and to create a false market for Vam shares. In your Committee's view these acts constituted deceptive and manipulative practices.

The Sales Preceding the Announcement

The announcement of the private issue with which the Committee was concerned was made to the Sydney Stock Exchange on 19 September 1969 by the directors of Vam (Committee Document 10-1), and it said, in brief, that 100,000 shares had been placed 'through' Ralph W. King & Yuill for $676,600. At the time, the market would have interpreted this announcement as meaning that a further issue of shares had just been arranged and that if and when quotation was granted some of these shares might be traded on the exchanges. Investors would have taken this increased supply into account in assessing the worth of the shares. Those investors familiar with the List Requirements of the stock exchanges would have been aware of the important clauses that insist upon listed companies announcing immediately any change in the issued capital, and they presumably would have assumed Vam was following these requirements. Other investors, had they thought about it, would probably have agreed that an essential requirement for a reasonably informed market is that directors of listed companies announce at once any changes in the number of shares on issue. In addition, although it apparently did not have any clear obligation to do so, it may have been reasonably expected that a leading broking firm such as Ralph W. King & Yuill would have endeavoured to ensure that a company it was advising was abiding by the stock exchange requirements. In fact, however, as this Committee's investigations have now revealed, in the placement of the 100,000 new shares Vam did not abide by the listing requirements, nor did it attempt to meet what we would have assumed were commonly accepted standards of disclosure. And the broking firm of Ralph W. King & Yuill appears to have countenanced and assisted in this behaviour.

Beginning on 29 July, in anticipation of receiving the 100,000 shares from the placement it had arranged and which was not announced until 19 September, the firm of Ralph Wo King & Yuill began the sale of those 100,000 Vam shares on the floors of the Sydney and Melbourne Stock Exchanges (the sales on the Melbourne Exchange being through an agent). A large number of the shares were also sold in London, and some were sold directly to the clients of Ralph W. King & Yuill (Ev. 2541). In an attempt to measure the impact of this selling on the market price of Vam shares at the time, the Committee collected statistics of market turnover as well as the records of Ralph W. King & Yuill's dealings. Between 29 July 1969 and 19 September 1969, there were thirty-nine trading days on either the Sydney or Melbourne Stock Exchanges. It was found that sales of the shares to come from the new issue took place on all but eleven of those days in more than a hundred different transactions ranging in size from 50 shares to approximately 5,000 shares. Throughout the whole period these sales accounted for about 22 per cent of all dealings in Vam shares reported by the Sydney and Melbourne Stock Exchanges, and on many days the sales amounted to between 40 per cent and 50 per cent of all transactions in Vam shares. There is little doubt that this large disposal of Vam shares by Ralph W. King & Yuill was one of the main reasons why the share price fell from $7 to about $5 over the seven-week period.

Those members of the public who were investors in Yam shares at this time were, therefore, dealing in a market which was largely under the influence of a broking firm that was selling new, unquoted and as-yet-uncreated shares in that market without revealing this fact to the public. Purchasers of these shares from Ralph W. King & Yuill had no way of knowing what these brokers knew - that it was Vam's intention to expand its share capital and that the Vam shares being sold by the brokers were already part of that expansion.

When Mr F.A. Close, the former chairman of Yam, appeared before the Committee in June 1972, he explained that 'in principle' he thought 'it was not a good thing' for new shares to be sold on the market without the public's knowing about it (Ev. 2603). He explained that in his view, however, 'you cannot make a placement with the knowledge of the shareholders', his reason being that 'operators who are not shareholders' would apparently force the share price down (Ev. 2606-7). Moreover, Mr Close explained that he had looked to his company's underwriting broker for advice on the question of when the announcement of the placement should be made:

At all times it was understood that the company would make no announcement during the period of a placement or prior to or during fund raising without the permission of the brokers. This is a fundamental clause that they put into every contract that I have seen. It would have been an implied and implicit part of any contract we had with Ralph King & Yuill. One of their members was Keith Phillips, and he was a respected member of the committee of the Stock Exchange. I would have been, and I believe properly so, impressed by his integrity, and his understanding and his advice on what I should do.

(Ev. 2605)

A Company Secretly Sells its Own Shares on the Stock Exchanges

The formal application for the 100,000 new Vam shares was made on 19 September 1969 by Pan Australian Nominees Ltd, a nominee company owned by Ralph W. King & Yuill (Committee Document 10-2). According to representatives of the broking firm who appeared before the Committee, Mr Peter Anthony Robert Brand and Mr Francis Reginald Johnson, the nominee company purchased the shares for the partners as 'beneficial owners' (Ev. 2539). On the face of it, Ralph W. King & Yuill acquired the new shares as principals and sold them as principals (Ev. 2543). After a close inspection of the records, however, the Committee feels bound to regard these transactions in a different light.

To carry out the sale of the Vam shares, Ralph W. King & Yuill opened a special ledger account headed 'Pan Australian Nominees Ltd, A/C Vam' (see Committee Document 10-3), and as the sales of the 100,000 shares took place from 29 July on, the proceeds were credited to this account. But from each sale as it occurred, brokerage was deducted, and also stamp duty. In other words, Ralph W. King & Yuill acted as though it was selling the shares as an agent for a client. And in reality, the client in this instance was the company, Vam, for periodically, Ralph W. King & Yuill paid to Vam the credit balance in the special ledger account. The Committee was told by representatives of the broking firm that three payments were made to Vam: on 19 August, $457,952.42; on 1 September, $176,972.27; and on 19 September, the day the market was first told of the arrangement to issue new shares, the balance of the account, $41,695.21 (Ev. 2539 and 2557~ The total amount of $676,619.90 raised by Vam from the issue of 100,000 shares was therefore paid to Vam in three instalments as the sales of the new, unquoted scrip progressed through King and Yuill on the market.

Mr Johnson did not himself act for his firm in arranging the Vam placement, but he thought that an arrangement had been made similar to one which we describe in the next section of this chapter, namely that Ralph W. King & Yuill agreed to pass on to Vam the sum they received from the sale of the placement shares, less commission (Ev. 2543).

Mr Close explained that it was not unusual for King and Yuill to make 'prepayment' to Vam for a placement of new shares, but he was 'certain ... that the shares were not sold at best on the market' (Ev. 2599). The Committee suggested to Mr Close that it would surely have been an 'extraordinary coincidence' if King and Yuill had first agreed with Vam on a fixed price for the 100,000 shares and then been able to realise exactly that amount in numerous sales on the market. But Mr Close thought otherwise:

If I had been in Ralph King & Yuill's position in those days and the market was as it was, I am pretty sure that, with the people they had and the control they had of their clientele and markets, I could have organised that as well as they did ...

(Ev. 2600)

In the Committee's view Ralph W. King & Yuill did not organise their sales so as to realise the exact amount previously promised to Vam; moreover, we do not believe the broking firm agreed to pay Vam a fixed price before it proceeded to sell the shares. Our opinion is that Ralph W. King & Yuill agreed to assist Vam directors to obtain a substantial amount of new funds by selling new shares for the company in the market; and so as to facilitate these sales it was mutually agreed not to make any announcement about the issue until the sales were completed. In effect, this amounted to the company secretly selling its own new shares on the floors of the stock exchanges and elsewhere with the connivance of the broker.

Delivery of Share Scrip

With the co-operation of Vam, a method was devised whereby Ralph W. King & Yuill was able to effect delivery of the scrip it had sold from 29 July onwards, even though the shares which had been sold were not allotted until 22 September. The procedure adopted to continue the pretenee that the shares which had been sold were part of the existing issued and quoted capital was for Vam to 'mark' transfers for a number of shares on each occasion the broking firm paid over part of the proceeds of the sales (Ev. 2545). This 'marking' process is a formal verification or endorsement made by a company on share-transfer forms, certifying that a parcel of shares, formerly owned by A, the seller~is now being held by the company pending completion of the transaction, after which the shares will be recorded as having passed to the ownership of B, the buyer. Thus, the marking is a necessary pre-condition for the seller to get payment for the shares. The marking in the case of the transfers of the non-existing Vam shares led each of the various purchasers to believe that the seller of the shares, Pan Australian Nominees, had lodged real scrip with the company, Vam, sufficient to cover the shares involved in each of the transactions.

As the shares concerned in these transfers had not been allotted, however, it was quite impossible for Vam to mark the transfers in the accepted way. The Committee inquired of Mr Close as to how markings could be effected to obtain cash payments when the allotments of shares had not been made. In his evidence Mr Close replied that this was a technical question which he could not understand: 'I would have been advised at the time', he added, 'and I would have accepted the advice of Ralph King & Yuill, their solicitors and our solicitors, and our public officer' (Ev. 2605). Mr Close was asked to make further inquiries and in later communication with the Committee he indicated that to the best of his recollection the transfers were 'marked' against scrip held by himself or his family (Committee Document 10-4). Since none of the shares held by Mr Close or his family were in any way involved in the transactions, we are confirmed in our view that the brokers and the company again resorted to improper practices to maintain the pretence that the sales were quite normal. The purchasers who received the marked transfers from Ralph W. King & Yuill continued to believe, as this firm evidently meant them to believe, that the shares were simply part of the existing issued and quoted share capital of the company.

Ralph W. King & Yuill, through Pan Australian Nominees, subsequently completed the formal procedure of applying to Vam for the 100,000 shares on 19 September, and an application was then made to the stock exchanges for the quotation of these shares. Quotation was subsequently granted on 9 October 1969, and this should have been the first day on which dealings in these new shares began. In fact, as we have seen, active dealing had been taking place since 29 July.

Mr Close said he believed that when King and Yuill periodically accounted to Vam for the sales it had made, Vam informed the stock exchanges of the progress made with the placement (Ev. 2600-01). However, neither the Committee nor the Sydney Stock Exchange has been able to trace these announcements, and in his letter to the Committee on 17 August 1972 (Committee Document 10-4) Mr Close said that he, too, had failed to find any documents to show that the exchanges had been told of the placement before 19 September.

Other Market Influences

Before King and Yuill began the surreptitious selling of the 100,000 shares, and also while the selling was in process, Vam issued to the stock exchanges a series of public announcements. On 10 July the stock exchanges were told of the 'discovery of gold' in the Burdekin River; on 20 August, of the purchase of copper leases 'in the Mount Isa/Cloncurry mineral field'; on 11 September, of the proposed issue of options to shareholders -underwritten by Ralph W. King & Yuill - 'which contains a considerable bonus element'; and on 12 September, of details of a joint venture with Amad in a gold project.

Neither Mr Brand nor Mr Johnson were able to inform the Committee whether Ralph W. King & Yuill had been consulted by Vam about these public announcements (Ev. 2542); and Mr Close told us that in his view Vam itself had no control over their timing, except in the case of the option issue. And with the announcement of the issue of options Mr Close expected the share price to decline, not rise. His reason was:

... because when a rights issue was announced amongst the Stock Exchange members there was, in those days, almost certainly shorting amongst their staff, knowing that there would be offers of shares at the new price, or options at the new price, and options contained leverage as against shares, and this would have undoubtedly tended to lower the price.

(Ev. 2602)

In our view, however, Vam directors were required to accept similar responsibility for and similar control over the timing of the various announcements between 10 July and 12 September 1969 as they had to accept for the timing of the announcement of the issue of 100,000 new shares. We are also of the opinion that the individual and combined effect of these announcements concerning the discovery of gold, the purchase of copper leases, and the option issue was to build up the demand for Vam shares at prices above what they would otherwise have been and to assist Ralph W. King and Yuill in disposing of a large volume of new shares on the market.

A representative of the firm of King and Yuill told us that at the same time as the 100,000 shares were being sold through one house account, a second house account was used for dealing in the Vam market (Ev. 2540). Our investigations showed that between 29 July and 19 September, in this second house account, numerous transactions (86 according to the Committee's calculations) took place on thirty days. About 12,200 shares were bought and 9,600 shares sold, leaving net purchases of approximately 2,600 shares (Ev. 2540). In a letter to the Committee of 15 August 1972, Ralph W. King & Yuill said that these dealings in the second house account were 'not affected by the placement' and 'do not appear to be other than in the ordinary course of business~ In our view, however, in considering the degree of distortion of the Vam share market at this time, it is necessary to look at the effect of the operations of the two house accounts. The net buying of the second house account was not particularly significant, but the combined effect of the buying and selling transactions in this account amounting to about 5 per cent of all reported sales in Sydney and Melbourne, must have been to add to the activity in the shares, which probably had the effect of bringing additional buying orders into the market. At the time, any such development would have facilitated the selling of the new Vam shares taking place through the first house account.

Brokers as Principals

Although we have explained how Ralph W. King and Yuill in effect acted as agents for Vam itself in selling 100,000 new shares on the market and elsewhere, in its application for the shares the broking firm appeared to be buying the shares as a principal. Mr Johnson also told us that the shares disposed of from the special account opened for the placement should have been sold by the firm as a principal (Ev. 2543). Among the purchasers of the Vam shares sold by Ralph W. King & Yuill were eleven clients of the firm (Ev. 2541), and we called for evidence from the brokers on the details of the contract notes that arose from these particular transactions. We first established that according to the rules of the Sydney Stock Exchange a broking firm should mark its contract notes to clients to show when it is selling the shares as a principal*; and we also confirmed that under the same rules the firm should not charge brokerage on the sales. When the contract notes from Ralph W. King & Yuill were examined, however, it was found that they were not marked to show that the broker had sold the shares as a principal, and on every contract note the client was charged brokerage as though the firm had been acting as an agent in the transaction (Ev. 2541). Mr Johnson said that he did not think the partners 'had realised' that the Vam shares sold to the clients had come from the placement (Ev. 2545). Apart from this comment the firm did not explain why, if it had been acting as a principal, the rules of the stock exchange had been ignored. Neither Mr Johnson nor Mr Brand were able to say whether the brokerage had been refunded to the clients (Ev. 2542).

** Article 99 of the Sydney Stock Exchange Limited's Articles of Association provides:*

In the event of a non-member agreeing to purchase from a member shares owned by the member at a price mutually agreed upon the member shall issue a Contract Note stating 'Sold to such non-member as principal'.

In the event of a member agreeing to purchase from a non-member shares owned by the non-member at a price mutually agreed upon the member shall issue a Contract Note stating 'Bought from such non-member as principal'.

The Committee finds that in the case of this private issue of Vam shares, the company, with the acquiescence of the broker, deliberately withheld information about the placement in the belief that this would enable the new shares to be sold to the misinformed public at a higher price than would have been possible had there been immediate and proper disclosure. In short, the public provided a large amount of capital to Vam without knowing it was doing so. To carry out the plan, the broker sold new shares continually on the floors of the Australian stock exchanges, that is, within the precincts of the stock exchanges. So for a period of at least seven weeks there was a substantial and continuing distortion in the market in Vam shares taking place before the eyes of the self-regulatory authorities. Yet, both Mr Close and Mr K.C. Phillips, a senior partner of Ralph W. King & Yuill, in response to a letter from the Committee, advised that neither the Sydney Stock Exchange nor the State regulatory authorities had ever made inquiries into the transactions arising from the placement of 100,000 Vam shares. It seems to us that the fact that the placement was announced on 19 September 1969 as having taken place at an average price of $6.76 a share when the market was close to $5.00 a share might have been expected to lead to an inquiry, but in the event no investigation was carried out.

North Deborah Mining Co. N.L. Raises $2 million through Ralph W. King & Yuill

The preceding section of this chapter was concerned with an analysis of one private placement of Vam shares which were absorbed into the share markets between July and September 1969. The placement techniques soon revealed a capacity for evolution, and a deeper appreciation of the scope for improper practices with these share issues can be obtained from an examination of a series of issues made by North Deborah Mining Company N.L. immediately following the Vam placement, in which again the broking frim of Ralph W. King & Yuill played a key role.

At 30 June 1969 North Deborah was a small company based in Bendigo. Shareholders' funds were only $262,000 and the company was making losses. In July 1969 the registered office was shifted to Melbourne, and soon afterwards announcements were released from this office about the company's preliminary investigations of 'potentially rich' lead, zinc and copper deposits, as well as the intention to begin percussion drilling on certain mineral claims held in Western Australia. But North Deborah's chances of raising a substantial amount of capital from the public to revive its fortunes and extend its life as a mineral explorer may have looked slim. The share price at about 30 cents at the end of September 1969 reflected relatively little interest by the market. Within four months, however, with the active assistance of Ralph W. King & Yuill, the directors of North Deborah had added about $2 million to the company's financial coffers through a series of private placements.

First Placement: September 1969

The first of the three placements took place just a few days after Poseidon's announcement at the beginning of October 1969 that it had obtained rich nickel assays from a prospect it was drilling at Windarra, Western Australia. On 7 October 1969 North Deborah gave warning to the excited share market that it was about to make an announcement 'which could markedly affect the value of North Deborah shares'. On 10 October (by which time the shares had climbed to $1.75) the market was told that the company had applied for eight mineral claims adjoining 'the most interesting of the Poseidon claims'. This 'News Release' also stated that $600,000 had been raised through the placement of 400,000 shares with Ralph W. King & Yuill. Following this expansion of issued shares, the directors obtained shareholders' approval of a large increase in the authorised capital - up from

3 million to 10 million shares of 25 cents each - and listed the company on the Sydney and Perth Exchanges in addition to the Melbourne Exchange. On 27 October the chairman also announced that the shares were being 'quoted unnofficially in London'. The ground was thus prepared for the period of large-scale international dealing in the company's shares that was soon to follow.

When Mr Cyril Charles Maskiell, the chairman and managing director of North Deborah, appeared before the Committee he explained that he had arranged to have the eight mineral claims pegged for a cost of about $1,800 and that they were the 'basis that caused that sequence of events as far as we were concerned, apart from the general market' (Ev. 2477). The sequence of events to which Mr MaskJell was referring included two further placements of a total of 250,000 shares in early January 1970 which raised a further $1.4 million. The Committee decided to investigate these two placements in detail.

Second Placement: January 1970 (50,000 shares)

At the end of December 1969 the Poseidon market had moved up to new heights and the North Deborah share price also had risen to about $2.50. Then, on 5 January 1970, in the highly speculative mining share market characterised by numerous tips and runs and a rising volume of sales, there was a sharp jump in North Deborah's price to $4.00, and a further rise to about $7.00 the next day. Most of the rumours associated with North Deborah apparently arose from speculation about the progress of the company's drilling on its mineral prospects in Western Australia. This drilling was not taking place on the claims next to Poseidon's but on those held by the company at Ora Banda and Siberia which were close to areas in which Great Boulder had reported nickel strikes. Mr Maskiell informed us that the company's geologists and advisers probably knew that drilling was proceeding and 'it was possible the word may have got around' (Ev. 2479). The 'word' was evidently most favourable, for at that time the market was valuing North Deborah at about $14 million, even though the company had no mine nor even what could be termed a mineral deposit with commercial potential. The words used by Mr Maskiell to describe his knowledge of the drilling at the time were: 'we did not know whether it would turn out very well, or poorly or anything else ...' (Ev. 2477).

Mr Maskiell himself was on holiday in early January when North Deborah's share price was rising so spectacularly, but on 6 January he returned to his office in Melbourne where he began arrangements that day for issuing new shares. His negotiations were with the Melbourne branch of the firm of Ralph W. King & Yuill which had arranged the placement of 400,000 shares in October 1969. The partner in charge of this branch was Mr G.S. Ficken, who Mr Maskiell regarded as a friend. Mr Ficken 'had given ENorth DeborahI a great deal of advice ... over a period of months' (Ev. 2476), and since the October issue of 400,000 shares he had discussed with Mr Maskiell when North Deborah would make a further placement.

Beginning immediately on 6 January, the day when Mr Maskiell returned to Melbourne, and the day the market price of North Deborah was at the peak of its 'run', Ralph W. King & Yuill proceeded to sell on the market the 50,000 shares which were later to be allotted in a private issue. This selling began two days before the public announcement of the placement on 8 January (Committee Document 10-5). To carry out the sale the broking firm opened a special house account from which, on 6 January, 16,600 shares were sold at prices between $7.00 and $6.50 a share to five Sydney brokers and to Ralph W. King & Yuill's Melbourne agent, a member of the Melbourne Exchange. (The sales made through Melbourne were reported in Sydney on 7 January). Many of these brokers would have been buying for brokers in other States, as well as for their clients. During trading hours, the shares were sold by operators on the floor of the Sydney Stock Exchange, and after trading hours they were sold from the firm's office to interstate and overseas brokers.

On 7 January, a further 27,550 shares were sold in the same way at prices between $7.00 and $5.00 to about nine Sydney brokers, one client and the Melbourne agent. Of the sales on this day, 19,000 shares were sold in London at $5.00 (reported in Sydney on 8 January). North Deborah's market price in Melbourne at the close of trading on 7 January was $4.80, down $1.70 on the previous day's closing price.

On 8 January, the remaining 5,850 shares from the parcel of 50,000 shares were sold, mostly at a price of $4.80 a share. In both Melbourne and Sydney the price closed at $4.20, down 80 cents in Sydney for the day, and down 60 cents in Melbourne.

So it was not until nearly all of the 50,000 shares had been sold by Ralph W. King & Yuill on the floors of the stock exchanges and elsewhere at prices beginning at $7.00 and finishing at $4.80 that the stock exchanges were informed of the company's intention to make a placement. The purchasers of these shares from Ralph W. King & Yuill were not told, and had no way of knowing, that they were buying shares in a company that had decided to change its capital structure through issuing more shares. Moreover, these purchasers were not told and, again, had no way of knowing, that the brokers were selling shares which, at the time, had not been granted quotation by the stock exchanges and had not been formally issued by the company.

Third Placement: January 1970 (200,000 shares)

As with the previous issue of 50,000 shares, the brokers and the company first agreed to make the third placement of 200,000 shares. This would be the most ambitious money-raising exercise of the series. Before the stock exchange was informed of the company's decision to increase its issued share capital, the brokers had begun heavy selling of the shares on the floors of the stock exchanges and elsewhere for the same house account used With the previous placement'. The brokers again did not inform the purchasers, among whom were several clients, that they were buying shares from a new issue which had not been announced to the market and had not yet been formally made.

If one were to judge by the dates of the public announcements, there was an interval of one week between North Deborah's share placements in January 1970. But in terms of the actual unloading of new shares by Ralph W. King & Yuill, there was no break in continuity. Immediately after the public was told something about the placement on 8 January, the broking firm set about anticipating the much bigger placement with heavy sales on the market. Though the public announcement of this third issue was made on 15 January 1970 (Committee Document 10-6), Ralph W. King & Yuill had sold 81,500 shares on 9 January. One London broker bought 43,000 of these shares, and the rest were sold to about twenty-three brokers in Sydney as well as to some clients; 2,000 shares were also sold to the joint trading account run by Ralph W. King & Yuill in London with a member of the London Stock Exchange. All the rest of the shares from this placement were sold on 12 and 13 January; London brokers again bought about half the shares and the rest were sold in Australia.

When Mr Maskiell was questioned about these placements, he said that he was expressly asked by the firm of Ralph W. King & Yuill not to make any announcement about the intention to issue new shares until it advised him to do so. The broking firm had made the same request with the first placement of 400,000 shares in October 1969, and North Deborah had, at that time also, delayed the announcement (Ev. 2480 and Committee Documents 10-7 and 10-9).

Ignoring the Official List Requirements

One of the A.A.S.E. List Requirements is that companies must notify the exchange immediately of 'Any decision by the directors to issue or recommend the issue of any securities of the company to its members, and particulars thereof', and: 'Any alteration of the issued securities of the company, and particulars thereof.' In view of Ralph W. King & Yuill's underwriting activities it would be reasonable to expect the firm to have been well aware of this requirement. When questioned about this rule in relation to the North Deborah placements, Mr F.R. Johnson, a non-member partner of Ralph W. King & Yuill, replied that he thought the obligation to report applied only after a broker who had received the placement had disposed of the shares (Ev. 2528-29). He said that, in his view, it was a stock exchange custom for the announcement of a placement to be delayed until after the broker receiving the placement had disposed of the shares (Ev. 2527-28). When asked specifically by the Committee if he included selling 'on the market' as one of the methods of disposing of shares before the public announcement, Mr Johnson said 'Yes' (Ev. 2528). In this way the stock exchanges List Requirements were interpreted to suit the advantage of the broker and the directors of the company; little consideration was given to the need to assist shareholders and the investing public in assessing the real worth of the company's shares. The Committee has no doubt that Ralph W. King & Yuill believed that an announcement of a private issue of a large number of new shares would have tended to depress the share price and that the timing of the announcement was deliberately delayed to provide the maximum opportunity of selling the new shares at a high price to unsuspecting public investors.

A Company Secretly Sells its Own Shares on the Stock Exchanges

In the formal arrangements made for the placements of 50,000 shares and 200,000 shares Ralph W. King & Yuill apparently agreed to purchase all the shares as principals (Committee Documents 10-7 and 10-9), and the application forms for the shares were completed by Ralph W. king Nominees Pty Ltd, the brokers' nominee company, on 8 January (for the 50,000 shares) and 19 January (for the 200,000 shares). However, instead of purchasing the shares at a fixed price as a principal, and then selling them or some of them at (hopefully) higher prices as a principal, retaining the difference between the prices as a profit, Ralph W. King & Yuill paid to North Deborah the exact amount obtained from selling the shares, less brokerage and stamp duty. In this reversal of normal procedure North Deborah would receive whatever an unsuspecting share market could be induced to pay for the stream of new shares that had entered incognito into the market.

Taking the placement of 50,000 shares first, between 6 and 8 January Ralph W. King & Yuill sold all these shares in numerous transactions in many markets at prices between $7.00 and $4.80 a share. The total amount received from these sales was $284,360. After the deduction of brokerage of 1.25 per cent and transaction duty of 0.2 per cent, the remaining $280,236.78 was the exact amount paid by the brokers to North Deborah when the shares were formally applied for by Ralphking Nominees.

The total amount received from the sale of 200,000 shares after numerous transactions at prices ranging from $6.00 to $5.00 a share between 9 and 13 January was $1,108,885. Once again, from these gross proceeds brokerage and stamp duty charges were deducted and the net amount of $1,092,806.17 was paid to North Deborah when the application was made for the new shares. Actually, before the formal arrangements for this second placement were completed, 205,350 shares had been sold, which meant that

5,350 of them had to be bought back. The sum of $1,108,885 was reached after allowing for the cost of buying back 5,350 shares.

The Committee found some difference between the explanations of the witnesses as to how the placement price was determined. Mr P.A.R. Brand, scrip manager of Ralph W. King & Yuill's Sydney office, stated in his evidence that there was not a 'set price' arranged for the Placement of North Deborah shares, but that North Deborahmwas simply paid the proceeds obtained from the sales of the shares (Ev. 2535). A partner of Ralph W. King & Yuill, Mr F.R. Johnson, also testified that 'apparently the agreement here was that the price would be whatever they could fetch in the market' (Ev. 2536).

Mr MaskJell, as chairman of North Deborah, gave a different account; he testified that the company and the brokers did agree on a price for the shares before Ralph W. King & Yuill sold them in the market (Ev. 2484-85). In his view the brokers had demonstrated their 'wonderful judgment' twice within a period of about a week in offering to buy shares in a placement at a price which was precisely what would be realised from subsequent sales (Ev. 2486). North Deborah also produced copies of letters (Committee Documents 10-7, 10-8, 10-9, 10-10) exchanged between the Melbourne office of Ralph W. King & Yuill and North Deborah setting out the terms of the placement and the price, and allegedly written before the sales took place.

In the Committee's view, however, it is totally implausible that, on two occasions within two weeks, a broker and a company could have settled on two average prices in advance for two distinct placements of shares which would in each case inticipate to the last cent the large sums of money which would be obtained as the result of transactions in several share markets at widely varying prices. We accept Ralph W. King & Yuill's evidence, that the amount to be handed on to the company would be the sum received from the sale of the shares. The representatives from Ralph W, King & Yuill who appeared before the Committee were unable to shed any tight on the dating of the letters allegedly exchanged between their firm's Melbourne office and North Deborah before the sales took place, as they had never seen them before· It is hard to escape the conclusion that these particular letters were backdated·

To summarise, even though Ralph W King & Yuill were shown in the documentation as purchasers of the shares as principals, and though the proceeds of the sales were credited to a house account that was owned beneficially by the partners, these steps in the chain by which the shares apparently reached the market concealed the real position. In practice, the brokers acted as the agents of North Deborah itself in the sale of new North Deborah shares on the floors of the stock exchanges and elsewhere. At the time the market did not know that it was dealing in this new scrip, and it had not been informed that the company had made arrangements to make a placement. These dealings took place during six trading days in January 1970, and in that period they accounted for about 37 per cent of the sales of North Deborah shares reported by the Sydney and Melbourne Stock Exchanges. Thus a high proportion of the market activity in North Deborah scrip arose from the clandestine disposal of new shares, and it is again to be noted that the stock exchanges failed to detect the abuse.

The Real Nature of the Placements

A notable feature of private placements is the way public companies such as North Deborah can repeatedly raise large amounts of capital from the public without being required to register and make available a prospectus relating to the purposes of the issues and the company's current financial position. The Committee's attention to this question was partly prompted by a belief that, as in the Vam case already described in this chapter, if a prospectus had been required, and the normal procedures for registering it had been followed, at least some of the abuses revealed so far in this discussion would probably not have occurred.

As the firm of Ralph W. King & Yuill is one of Australia's well-known underwriters with a long experience of arranging capital issues with and without prospectuses, and as it acted as North Deborah's financial advisers throughout the period when North Deborah raised about $2 million in four months, the Committee asked the firm on 9 March 1972 to explain why there had not been a prospectus accompanying the issues by North Deborah. Mr Keith Collie Phillips, a member of the Sydney Stock Exchange and a senior partner of the firm, replied by letter on 24 March (Committee Document 10-11):

As far as I am aware, my firm in its capacity as brokers to North Deborah, was not required to concern itself with the question of whether the issue of a prospectus under these circumstances was necessary or desirable. This would be a matter for North Deborah. However, my view is that no prospectus would have been necessary as no offer to the public of the shares in question was involved. My view in this regard has been confirmed by Counsel.

The Committee has two comments to make on this matter.

First, Ralph W. King & Yuill say that with the North Deborah placements there was 'no offer to the public'. It is true, as already shown, that the broker's nominee company made the application for the shares, but these applications were made after the shares had been sold in the public market. Whatever the strict legal position, the realistic interpretation of what happened is that the North Deborah shares were sold to the public, and members of the investing public who bought these shares were intentionally kept ignorant of the fact that they were buying shares arising from a new issue in order that they could be induced to pay a higher price than they would otherwise have done.

The Committee wishes to emphasise that the essence of the share placements we have described is that they were public issues - issues of new capital at extremely high prices direct to the general public and not to existing shareholders of the company or to private persons having a knowledge of what they were buying. They were in reality public issues, and in our view they should have been accompanied by prospectuses. This requirement was avoided by concealment of their true nature. The only participants in the market who were aware of their true nature were the brokers, Ralph W. King & Yuill.

Secondly, Ralph W. King & Yuill's reply that it 'was not required to concern itself with the question of whether the issue of a prospectus under these circumstances was necessary or desirable' suggests an attitude of unconcern about the effect of certain market practices upon the investing public which was one of the many factors borne in mind by the Committee in thinking about the type of regulatory system suitable for Australia. Representatives of the exchanges have often said that their members are not just concerned with maximising their profits while following the minimum requirements of the law. They believe that their members adopt and impose a standard of ethical behaviour on themselves which is stricter than that reflected in the law. Moreover, spokesmen for the stock exchanges believe that members also concern themselves with market practices generally, and endearour to ensure high standards beyond the area of their own jurisdiction. Yet, in the reply quoted above, the view is expressed by a prominent firm of stockbrokers that, when it was arranging for the sale to the public of a large volume of shares by a company client, it was not concerned with whether it was 'necessary or desirable' that the company issue a prospectus. If this is the attitude and manner of operation of brokers, the public must, inevitably, demand much closer government supervision of the markets.

Should Clients have been charged Brokerage?

Although, in the Committee's view, the Ralph W. King & Yuill firm acted as though it was North Deborah's agent in the sale of new shares on the market, just as it did in the sale of Vam shares described earlier in this chapter, the firm itself maintained that, as with the Vam sales, it was acting as a principal. According to the rules of the Sydney Stock Exchange, Ralph W. King & Yuill should, therefore, when selling the North Deborah shares to clients, have disclosed on its contract notes that it was dealing as a principal. As in the case of the Vam dealings, we decided to make a test check of the contract notes covering the sale of the North Deborah shares to clients and, after looking at the firm's scrip ledger, five instances were selected for examination. According to the contract notes, in each transaction the broking firm had been acting as an agent, not as a principal, and the clients were all charged brokerage.

The representatives of Ralph W. King & Yuill who were before the Committee on 21 June 1972 offered two explanations of the firm's apparent failure to abide by the rules of the stock exchange. Mr Brand said that the clients concerned were already seeking to buy North Deborah shares at the time and the firm of which he was an employee had not especially approached them with an offer of shares from the placement. He added: 'they would have had no knowledge, at the time, that we were doing the placement' (Ev. 2526 & 2537). Mr Johnson said: 'it was an error ... somebody put the wrong designation on a little voucher ... They should have gone as principals' (Ev. 2526)o He also told the Committee that the firm's first knowledge of clients being charged brokerage for shares bought from the North Deborah placement was when this Committee called for the contract notes in

April 1972; he also said that 'nothing has been done about it' (Ev. 2543).

Two months later, after a senior partner of Ralph W. King & Yuill had studied the transcript of this evidence, he wrote to the Committee offering a further explanation (Committee Document 10-12). This letter was followed up by the Committee (Committee Documents 10-15 & 10-14) and we were given to understand that in King and Yuill's view it was incorrect to infer from their records that the firm had been acting as a principal in its dealings with the five clients. In the first place, King and Yuill said that even though the scrip ledger showed that certain purchases by clients were balanced by sales from one of the firm's house accounts, this did not necessarily mean the firm had been acting as a principal in the transactions. According to King and Yuill, the firm had a house account into which it 'booked' shares temporarily before 'booking' them out again at the same price later in the day. Apparently when the house account was used in this way it was looked upon as a kind of 'clearing account', which is why the firm did not regard itself as acting as a principal with its clients. King and Yuill said:

It is our opinion that the analysis of the line by line reporting as shown on the scrip ledger card is not sufficient to assess the trading during a particular day but that all transactions must be examined in total.

(Committee Document 10-12)

The Committee was not told why the house account was used in this way with the dealings in North Deborah shares, but at various times in the course of our inquiries we were told that this practice occurs during a busy market when there are many orders to complete. The house account acts as a convenient 'home' into which purchases for various clients can be accumulated during the day and from which a distribution to clients can take place with less haste later in the day.

We recognise that in many instances Ralph W. King & Yuill's house accounts were probably used in the way we have described, but with some of the transactions in North Deborah shares there is the difficulty of explaining why the special house account that had been opened for the sale of placement shares was shown as the seller of North Deborah shares to clients rather than the firm's normal house account. However, the evidence given to the Committee on these questions remained inconclusive owing to the complicated nature of the transactions and the changing and involved explanations of them. We note, nevertheless, that because of the way the house accounts in a broker's office can be used for various purposes concurrently, an investigator who is subsequently looking at the records is likely to find great difficulty in unravelling the nature of the transactions that have passed through the accounts.

In the next section of this chapter we present evidence to show that the King and Yuill firm, when dealing as a principal with its clients, quite commonly charged brokerage on the transactions, contrary to the stock exchange rules.

Trading before Quotation had been granted

Although the 250,000 shares from North Deborah's second and third placements were sold to the public in early January 1970, the Melbourne Stock Exchange did not grant quotation for the shares until 26 March 1970. It seemed to the Committee, therefore, that Ralph W. King & Yuill would have been unable to deliver the shares which they had sold to the purchasers until after 26 March, when quotation was granted. Before then, it would seem that the purchasers would refuse the delivery of shares which were not quoted and so not marketable on the stock exchange.

In fact there was no such refusal. North Deborah's directors passed a resolution on 14 January agreeing to allot to Ralphking Nominees 250,000 new shares, and on 10 February North Deborah's share registry began to transfer shares from this allotment into the names of the people who had bought the shares disposed of by Ralph W. King & Yuill. The purchasers of the shares did not complain or question the procedure because they did not know what was happening, and they had no reason to suspect that they had bought unquoted shares. Ralph W. King & Yuill were confident that in due course the stock exchange would grant quotation for the new shares, when they would become indistinguishable from the existing quoted shares in that company. In the meantime the partners of Ralph W. King & Yuill were apparently not concerned that they were continuing to hold out that the shares they were passing on to the purchasers were part of the listed and quoted share capital, when this was not so at all. In this way, for well over two months, a large number of shares from the North Deborah placements were traded on the stock exchanges before the stock exchanges had agreed that such dealings could take place.

Ineffective Stock Exchange Inquiries

On two occasions while Ralph W. King & Yuill were selling shares from the placement of 50,000 shares, the Melbourne Exchange queried the company. On 7 January, the day before the announcement of the placement, the assistant secretary of the Melbourne Exchange, following an inquiry from the Sydney Exchange, asked North Deborah if it knew of any reason for the rise in price of the company's shares. The company's secretary replied on 7 January that he knew of no reason for the rise in price. Mr Maskiell told the Committee that when the secretary replied to the stock exchange's inquiry he did so without the board's authority. Mr Masktell also said, however, that he would not have altered the secretary's reply to the extent of telling the exchange about the company's arrangement to issue new shares.

On receiving advice of the placement from the company on 8 January, the Melbourne Exchange wrote to the chairman of North Deborah on 9 January (Committee Document 10-15) pointing out that the company had said, on 7 January, that it knew of no reason for the rise in price of its shares, whereas the next day it had announced a large share placement. The Melbourne Exchange also queried the fact that the company had announced a placement of shares at $5.60 a share, when the market price at the time of the announcement was only $4.20. On the face of it, an explanation was called for.

In his reply of 9 January the chairman of North Deborah, Mr Maskiell (Committee Document 10-16), stated that when the placement was discussed with Ralph W. King & Yuill 'the share price ranged from $6.50 to $7.00, and 'to gain the best value from the viewpoint of the company, the share placement was immediately arranged at $5.60 per share ...' Our investigations showed that the first day on which the share price ranged from $6.50 to $7.00 was 6 January, and this was the day on which the stock exchange should have been informed of the new issue. However, the chairman of North Deborah did not explain in his letter to the stock exchange why the announcement was not made before 8 January, and he was not asked for any further explanation by the exchange. Thus the steps taken by the Melbourne Exchange to inquire into some of the circumstances surrounding the placement of 50,000 new shares were quite ineffectual in uncovering the fact that North Deborah had delayed the announcement of the placement while the firm of Ralph W. King & Yuill was disposing of these new shares on the stock exchanges.

The Victorian Government authorities also looked at some aspects of the dealings that took place in North Deborah shares in January 1970. Records in the Melbourne office of Ralph W. King & Yuill were examined and a partner was interviewed.

That took place in May 1970. But after more than three years the matter has been taken no further, as far as the public and this Committee are aware.

Reporting the Drilling Results

As we said earlier, the rumours that apparently gave rise to much of the speculation in North Deborah shares in January 1970 were about the results expected from drilling in the company's nickel prospects in the Siberia and Ora Banda areas in Western Australia, and while the sales of shares from the placements were taking place the company had let the exchanges know that a report on this drilling was 'due shortly'. The first report was received by the Melbourne Exchange on Friday, 15 March 1970, at 1.33 p.m., and in this the directors stated:

The Company's consultants reported verbally today that the first diamond drill hole at Ora Banda has been continued past the estimated target of 500 feet to 650 feet, in metabaggro, pyrite and chalcopyrite, with encouraging in nickel values. They sought and have been given approval to continue drilling in this hole.

(Emphasis added by the Committee)

The second report was received by the exchanges on Monday, 16 March 1970, at 9.27 a.m., when the company said:

North Deborah Mining Company N.L. after continuous contact with its consultants has now received the following report:

Ora Banda diamond drill hole No. 1 finished at 695 feet. Mineralisation of no commercial value. Results being examined to asses significance with respect to further exploration work.

(Emphasis added by the Committee)

These self-cancelling statements are a further illustration of the unsatisfactory standards adopted by the North Deborah directors to their responsibilities in public reporting.

From the second statement investors could tell that the rumours which had accompanied and provoked the rise in the share price some months earlier had had little foundation. Nevertheless, the company still had most of the $2 million it had raised through its illicit placement techniques. The stock exchanges did not receive and apparently did not seek any detailed explanation from North Deborah of the purpose of these large capital raisings, and the company did not issue a prospectus disclosing its intentions. The records now show that some of the money was spent on exploration, but a far greater amount, together with further capital raised, was lost on 'Investments' which, in June 1972, were shown as worth about $1.9 million less than they had cost. At the time of writing, the shares which had been secretly filtered into the market in January 1970 at prices up to $7.00 each were selling for 8 cents.

Allstate Explorations N.L. Raises $2,062,500 through Ralph W. King & Yuill

Ralph W. King & Yuill underwrote the birth of Allstate Explorations N.L. as a public company in June 1969, when an issue of 5.5 million shares of 25 cents denomination, paid to 10 cents each, raised $550,000. Within a period of about six months, a further $2,062,500 was raised by private issues in which Ralph W. King & Yuill again collaborated. In this section we report on these private issues and show how they illustrate a further stage in the process of evolution of placement techniques and abuses which has already been noticed in the transition from the circumstances of the private issues of Vam Limited to those of North Deborah Mining Company N.L.

With the Allstate placements, the use of market operations by Ralph W. King & Yuill's house account in order to condition or manipulate the share market for the unknowing absorption of the newly issued shares at transiently high prices was made more confidently and forcefully than in the earlier examples. In this example also, it will be found that Ralph W. King & Yuill could be more truly described as principals, rather than agents, in the surreptitious process of unloading new shares on the Australian and London markets. Moreover, a substantial body of evidence in Allstate's case would indicate that here was a company publicly floated with a degree of recognition from the start on the part of some of those associated with it that the greater portion of its necessary working capital might be obtained from future placement issues. This soon proved to be so. Opportunities to raise great amounts of money were not only seized within about six months of the flotation, but those opportunities were positively created by tactics of prompt association with the early 'Poseidon boom' in the popular imagination, so that most of Allstate's working capital was to come from the placements, and the prospectus which had accompanied the launching of the company came rather to assume the appearance of a relatively minor, though necessary, early formality in the fund-raising process.

Events Leading up to the Placements

Allstate was almost simultaneously adopting the same tactics as North Deborah when it geared its capital expansion to the first flush of the 'Poseidon boom'. The first announcement by Poseidon N.L. of a rich nickel assay was made on 1 October 1969 with dramatic consequences in the share market. A few weeks later, on 13 and 14 October, the directors of Allstate made announcements of new developments, explicitly linking their company with the prospects of Poseidon and with two other stocks which were then most prominent in the glamorous light of the nickel boom, namely Great Boulder N.L. and Carr Boyd Minerals N.L. The statement made by Allstate Explorations on 14 October as relayed by the Sydney Stock Exchange to the other exchanges, reads as follows:

Allstate Explorations N.L.

The Directors advise that the company has negotiated an agreement to acquire an option over eight mineral claims, each of approximately 300 acres, in the Laverton area. Four of the claims are situated one-half mile northwest of the boundary of the claims held by Poseidon N.L. and the other four claims are situated one mile southeast of the boundary of the claims held by Poseidon N.L ....

It is intended to commence shortly a program of geochemical and geophysical exploration upon the areas.

K.B. Lewington
Secretary

This message bears a notable resemblance to the statement which directors of North Deborah had made a few days earlier saying that North Deborah had applied for eight mineral claims in the Laverton area, all eight being located in this case to the southeast of Poseidon's search area.

The other message from Allstate during this fillip to the nickel boom, and linking the company's prospects with those of Great Boulder and Carr Boyd Minerals, was transmitted from the Sydney Exchange to other exchanges on 13 October 1969 in these terms:

Allstate Explorations N.L.

The Directors advise that the company has acquired an option over five mineral claims totalling 1,500 acres in the Carr Boyd rocks area of the North Kalgoorlie gold field in Western Australia.

The claims are located northwest of the claim of Great Boulder N.L. and Carr Boyd Minerals N.L. The claims under option immediately adjoin the claims of Carr Boyd Minerals N.L.

A programme of geochemical and geophysical exploration will commence shortly.

Secretary.

Overnight, or more strictly over two nights, Allstate Explorations had become one of the 'nickel stocks, in the share market's estimation. Up to this time, nickel search areas had not played any part in the company's stated program of specific mineral exploration projects; in fact, the prospectus had not specified any mineral interests in the State of Western Australia. Now the share market responded to the transformation, and with a touch of the anticipation of the official messages of 15 and 14 October which we have previously noted in the case of North Deborah's market also. From a closing price of 37 cents on 3 October, the Allstate shares had moved to 94 cents on Friday, 10 October 1969 which was the last trading day before the two messages from Allstate claiming propinquity to glamorous nickel areas. On Monday, 13 October, the market in the shares closed at 95 cents. A week later, the price was $1.78, and on 4 November the closing price was above $2. Then the price eased, and it did not return to the $2 mark, or above, until a few days before the first of Allstate's placement issues.

<u>The First Misleading Announcement.</u>

On 26 November 1969 the stock exchanges were informed that Ralph W. King & Yuill had 'placed 400,000 shares of the company with clients at $2'. There are several comments to be made on this announcement. First, it gave the impression that Ralph We King & Yuill had acted as an agent in the transaction, whereas the firm's role was that of a principal, dealing on its own account with Allstate Explorations through its wholly-owned company Ralphking Nominees Pty Ltd. Secondly, by the time of this first announcement, King and Yuill had already 'pre-sold, on the

Australian on-'change markets as well as in overseas markets and to clients the net equivalent of about 47 per cent of these 400,000 new shares being issued at $2 each. Once again, public investors were misled. They had unknowingly bought the new shares, and stock exchange dealings had been taking place in these shares, before any announcement was made to the stock exchanges.

One question which interested the Committee with this issue was whether any specific date could be attributed to the placement. As we have said, the announcement of 26 November indicated that the shares had already been placed. However, some days later, on 1 December, the King & Yuill firm wrote to Allstate confirming its intention in the future to accept the shares; and it was not until 15 December that King and Yuill made application for the 400,000 new shares enclosing a cheque for $800,000 with the application. If the available documents are taken in their own time sequence, conflicting variations are found in their use of tenses:

1. The Minutes of a board meeting of Allstate held on 26 November, at which two of the four directors, Messrs W.L. Young and D.L. Elsworth were present, record that: 'The chairman reported that an offer had been received from Ralphking Nominees to take up 400,000 25 cent ordinary shares in the Company paid to 10 cents at a price of $2 per share. It was resolved that the Company accept the application ...' (The offer referred to was evidently a verbal one, the culmination of a number of verbal discussions between the broking firm and the directors).

2o On the same day, the directors made their public announcement that 'Ralph W. King & Yuill, members of the Sydney Stock Exchange, have placed 400,000 shares of the company with clients ...'

3. On 1 December, King and Yuill wrote to the chairman of Allstate, saying: 'We confirm the arrangement whereby we will accept 400,000 shares (new issue) in your Company ... On 15 December 1969, we will lodge with you an application for that number of shares ...'

4. On 15 December, Ralphking Nominees wrote to Allstate saying 'We ... hereby apply for 400,000 shares ...' (Emphasis supplied by the Committee in these quotations.)

The Committee has concluded that such ambiguities were an essential part of the exercise; it was of the nature of the operation that the placement should have no unequivocally determinable date.

Roles of the House Account in 'Conditioning' the Market

Following the flotation of Allstate Exploration Ralph W. King & Yuill continued to have a relationship with the market in the company's shares which entailed its using a house account as a more or less continuous stockist of Allstate shares, as part of a wharehousing function connected with the marketing of them. Thus a continuity of action was maintained when the broking firm made use of a house account to 'condition' the market before carrying out a large sale of the placement shares from that house account o

Examination of the broker's records showed that in the two days before the public announcement, that is on 24 and 25 November, Ralph W. King & Yuill moved on to the local markets as a large buyer of Allstate shares for its house account. The effect was to give support to the price reported to clients of brokers and in the Press as 'the market price' for Allstate shares. Additional public demand for the shares would have been expected in response to the higher activity and rising price. The records also showed that over these same days the broking firm sold for its house account still larger quantities of new and formally non-existent shares, substantially to brokers in London and Glasgow who would naturally have assumed they were buying shares already on issue and who had no knowledge of an impending increase in the supply, let alone of the fact that they were themselves absorbing yet-to-be-created shares. Over the two days, the buying support involved the purchase of 133,000 shares for the house account and the sales to London and to local clients of the placement issue totalled 324,000 shares.

On the morning of the eventful 24 November, when Ralph W. King & Yuill began this market 'conditioning' and pre-selling process, the Sydney Stock Exchange sent a message to other exchanges advising that there was an announcement pending from Allstate Explorations. The Melbourne Exchange sent urgent requests to Sydney for prompt amplification, saying in one tele-printer message: 'Could you please advise time when we can expect to receive Allstate report as market is going wild'. On the same afternoon, the text of Allstate's announcement was released. It referred to drilling results in its copper and lead-zinc prospect at Hall's Peak, New South Wales, and concluded with a sentence concerning the nickel claims in Western Australia: 'Magnetic and geochemical surveys have been arranged for the Company's nine claims in the Laverton area, commencing early in December'. What the stock exchange authorities did not reveal to the public was that the transactions of one of their own member firms had quite a lot to do with the market going 'wild', for, as our investigations showed, over the two days 24 and 25 November, the firm's dealings on its own account represented no less than 63 per cent of the gross combined turnovers in the stock recorded by the Sydney and Melbourne Exchanges.

10.45

Ralph W. King & Yuill's heavy selling of Allstate placement shares on the London market was done substantially through a joint account which the firm held in equal partnership with a London broking firm. An examination of the records indicates that King & Yuill's use of London as a selling outlet had been an important part of the tactical exercise. It facilitated, first, the promotion of higher prices for Allstate shares when co-ordinated with buying on the on-'change Australian markets, and secondly the smooth disposal of the placement parcels in quick time. The interplay of the overseas and Australian markets on almost a 24-hour, round-the-clock basis gave scope for considerable exploitation; yet it could also be given an air of conforming with ordinary 'arbitrage' routines when~ for example, the stock exchange price of a stock had been systematically raised by the end of a day's trading in this country, so that differentials suitable for 'arbitrage' then appeared between the last quoted prices in Australia and in London.

After the Committee had examined the processes of interplay between the London-Australian markets in the case of Allstate shares, it invited members of the firm of Ralph W. King & Yuill to comment on its tentative conclusions. The invitation did not meet with any denial of the Committee's conclusions. An example will now be given in an extract from the evidence of Mr F.R. Johnson, a non-member partner of King and Yuill and Mr P.A.R. Brand, the firm's scrip manager who were deputed by Ralph W. King & Yuill to represent the firm in this section of the Committee's hearings. The Committee does not wish to suggest that these witnesses were mainly responsible for the general development of the firm's placement techniques~ but their evidence in the matter has not been challenged by more senior members of the firm who have read the transcript. The following passage of the transcript takes up from the point where we had been questioning the witnesses regarding Ralph W. King & Yuill's house-account transactions in Allstate shares on 24 November 1969, which included a sale of 100,000 shares to the London joint account with R. Layton & Co.

Senator Rae: So is our reading of your records accurate?

Mr Johnson: Yes.

Senator Rae: It also appears that on 24 November no shares were released onto the Australian markets, except those which were sold to clients of the firm. But on that day, that is 24 November, there were numerous transactions in which your firm bought from Australian brokers for the house account a total of 118,000 Allstate shares at prices ranging between $2.05 and $2.45 per share. Does that appear to be correct? [Subsequent checking by the Committee showed that Ralph W. King & Yuill did sell relatively small quantities of shares on the Sydney Exchange on 24 November.]

Mr Brand: That appears to be right.

Mr Johnson: We thought the reference to where they were bought from would appear in your sheets there.

Senator Rae: So that in summary what was happening on 24 November was that you were doing three things:
(1) you were selling to clients; (2) you were selling to the London joint account; and (3) you were buying on the Australian market, buying at increasing prices; and the possibility that I put to you is that this was in the form of supporting the Australian market in those shares?

Mr Johnson: I could not comment on that, because I was not involved in the transaction and did not hear anybody give any instructions or do anything of this nature. It would appear that way.

Senator Rae: Thank you. What again appears by way of summary of the records that you have supplied to us is the following: Between 20 November 1969 and 6 January 1970, which the period covering the two placements, your firm purchased for its house account 359,000 Allstate shares, received placements of a total of 1,000,000 Allstate shares, and sold a total of 1,170,500 shares; that throughout that period that buying was taking place on the Australian market, a large part of the selling was taking place on the London market?

Mr Johnson: I take your word for that.

Senator Rae: Well, if that is not accurate, I wonder if you would have a later look at it in the transcript [the transcript of witnesses' evidence, subsequently sent to them for checking] and let us know? Now who would have been the partner or partners or employees of the firm who were in charge of the business which I have just summarised? The names mentioned so far are Mr Walton, [Mr Ian C. Walton, the senior partner of Ralph W. King & Yuill at the time of the transactions who subsequently retired from the firm] as having been one of those primarily involved in the placements; Mr Phillips, as apparently involved in some of the discussions in relation to the second placement; and yourself, Mr Johnson, in relation to having --

Mr Johnson: Written letters.

Senator Rae: Having written some letters or made some notes. As I understand it, maybe not much further knowledge than that.

<u>Improper Charging of Brokerage</u>

Following the public announcement of the first placement, the broking firm continued over the next two weeks to act simultaneously as buyer and seller of Allstate shares, on a reducing scale. Test checks of contract notes which the Committee has made, together with evidence obtained from members of the broking firm (Ev. 2545-47 & 2558), have shown that Ralph W. King & Yuill did not disclose its role as principal in transactions with clients, and that it charged brokerage as though it were acting as an agent in the transactions.

Senator Georges: It seems to me that it was common practice of brokerage firms - in other words the practice spread across a number of firms - to charge brokerage on all the transactions.

Mr Brand: We cannot speak for other firms but I do know from our own experience that this was something that had been done during the boom - as we call it. On any transaction that was done on the floor, brokerage was charged on it, where a ticket had actually been issued, and this was where the fault was created.

(Ev. 2558)

In addition to the substantial net profits it made on the turnover of Allstate shares and to the brokerage revenue obtained, King and Yuill received from Allstate a payment of $10,000 for its services in the operation. When paying the $10,000 on 15 December, Allstate described it as an 'underwriting fee', although the circumstances of the operation, as described, had not involved underwriting in the generally accepted meaning of the word,

The Second Misleading Announcement

The 'Poseidon boom' surged further ahead in late December 1969 when Poseidon held its exultant annual general meeting. In that climate, Allstate made its second placement issue (or combination of issues), involving a greater number of shares at a higher average price. · The date of the placement is once again indeterminate; there is evidence of quick and hasty revisions upwards of the proposed scale of the placement and the price obtainable; and the pre-selling by Ralph W. King & Yuill of virtually the whole 600,000 shares involved was on this second occasion carried out more swiftly and decisively, ahead of any public announcement of a placement issue, and with a minimum of simultaneous buying of Allstate shares on a local market which needed little support from the broking firm.

The evidence of revised proposals consists mainly of three extant letters from Ralph W. King & Yuill to Allstate, each evidently catching up with previous verbal discussions. On 51 December 1969 King and Yuill wrote:

We refer to a conversation between a representative of your company and our Mr Phillips and confirm that we have taken as principals 100,000 new shares in your company at a premium of $1.90 a share (toe. $2.00 per share) for subsequent placement with our clients ...

We propose to settle with your company in the New Year on a date to be arranged.

(Emphasis by Committee)

But the records show that Ralph W. King & Yuill had sold as principals well over 100,000 Allstate shares in the two days preceding this letter, and as this had involved selling much more than its 'warehouse' stocks of Allstate scrip at the time~ the sales had been in anticipation of the 100~000 placement. This may explain the letter's confident use of the past tense ('have taken'), contrasting with the future tense which had been used in Ralph W. King & Yuill's letter relating to the earlier placement.

On the day of this letter, 51 December, King & Yuill sold a further 148,000 Allstate shares, which would have left it in a heavily exposed 'short' position unless further placements of new shares were firmly expected. Still no public announcement relating to the 100,000 placement was made.

On 5 January 1970, King and Yuill wrote two letters to Allstate. One of these letters said:

Further to our letter of the 31 December, 1969, referring to the placement of 100,000 shares in your company, we confirm that we have taken on the same terms and conditions a further 250,000 shares, a total of 350,000 shares of this placement.

The other letter of 5 January reads (in part):

~e refer to a conversation between a representative of your company and our Mr Phillips and confirm that we have taken as principals 250,000 new shares in your Company at a premium of $2.15 per share (i.e. $2.25 per share) for subsequent placement with our clients ... we have yet to arrange a settlement date ...

(Emphasis by Committee)

But there was no 'subsequent placement with clients', nor any scope for it, since Ralph W. King & Yuill had already, as principals$_{T}$ sold nearly all the shares mentioned in these two letters to unsuspecting buyers on the Australian markets and overseas.

The first public announcement by the directors of Allstate, assembling together the placements mentioned in the three broker's letters of 31 December and 5 January, was made on 7 January 1970. By that time, as a member of Ralph W. King & Yuill testified in evidence to the Committee (Ev. 2559-60), the broking firm had not only sold the 600,000 shares quoted in the public announcement but had also depleted its 'wharehouse' stocks of Allstate scrip from about 67,000 to 58,000.

In most respects, the procedure in the second set of Allstate share placements followed that which has been outlined in our account of the first placement. The final settlements arising from the second round were made on 11 February 1970 when Allstate sent a cheque for $15,781 to King and Yuill for what the company again described as 'the underwriting fee'. Subject to that expense, the second placements yielded Allstate an amount of $1,262,500, and the two share placements made in a period of five or six weeks by processes withholding much essential information from the subscribing public had raised $2,062,500 or nearly four times as much as the prospectus issue had yielded some six months previously.

Throughout the period from late November 1969 to 6 January 1970, the purchases and sales of Allstate shares by King and Yuill's house account totalled 1.53 million shares. As a proportion of the gross combined sales reported by the Sydney and Melbourne Exchanges of 4.8 million Allstate shares during the same period (including sales to overseas markets), Ralph W. King & Yuill's house-account transactions therefore represented 31 per cent. Investors, analysts and chartists looking to the exchanges for reliable statistics on the daily turnover and prices of Allstate quoted shares would not have known that these indicators of the level of market activity were being misleadingly boosted. They would have seen high turnover figures linked with rising prices, particularly during periods just preceding the placements, but the published information did not reveal that the reported turnovers included sales of one million new shares to be made available from placements, and that an important reason for the rise in the recorded turnovers and prices at certain times was that one broker was using his house account to bring this about.

Interchangeable Roles

In the discussion of the share placements made by Vam Ltd and North Deborah Mining Co. N.L. earlier in this chapter, the Committee has explained wily it considers that each company itself was for effective purposes the principal in those transactions: a company secretly selling its own shares in the market and using Ralph W. King & Yuill as agents. In the case of the Allstate placements, however, we have characterised Ralph W. King & Yuill as the principal in the share dealings, and the distinction needs to be briefly discussed. Unlike Vam and North Deborah, the company Allstate Explorations did not receive the full and exact proceeds (after stamp duty and brokerage charges) obtained from the sales of its new shares in the market. The prices agreed upon between Allstate's directors and the broker were not simply equated with the average of the prices which had been or would be received in all the transactions in the market, whereas in the Vam and North Deborah placements they were so equated. Something was left for a margin of profit or loss to be taken by the brokers 'on the turn' in the Allstate issues.

This is the basis of the formal distinction which we have drawn. Yet we also recognise that the difference could be more formal than real. It is clear from the foregoing narrative that the terms and conditions of the Allstate placements were pitched close to the ruling market (though at the beginning in November 1969, the market itself had to be 'conditioned') and that they were quickly adjusted to changes in the market. Moreover, the only recorded commitments given in writing by Ralph W. King & Yuill to pay those agreed prices for stipulated quantities of new shares were made _after_ the shares (or most of them) had already been sold in the market, so that there was a strong retrospective element, a high degree of _ex post facto_ calculation, in the minds of the broking firm applying to the placement prices negotiated for Allstate as well as those for Vam and North Deborah. Mr David Lindsay Elsworth, the present chairman of Allstate, who was a director but not chairman at the time of the share placements, said in evidence to the Committee that he had no knowledge of any anticipatory selling of the new shares being made by Ralph W. King & Yuill (Evo 2552-54). From the viewpoint of the broker, however, a sense of the similarity, rather than of difference, between the services rendered to Allstate and North Deborah, is shown by the fact that King and Yuill charged both companies a 'fee' at the same rate, namely 1¼ per cent of the amount of money handed over to the company.

Taking Advantage of an Uninformed Market

As already noted, the Allstate company's prompt action in October 1969, to become associated with the Poseidon nickel boom had made the placements possible on such terms. In their report for the year ended 30 June 1970, however, the directors of Allstate said that the results of geological investigations in the areas near to the Poseidon leases were 'not of immediate economic interest', while those near Carr Boyd 'did not indicate any geology of interest'. This diminution of significance of the areas has continued. In their annual report for the following year, released in September 1971, the directors referred to a final petering out of some joint drilling activities at Windarra South and they made no reference to the claims in the vicinity of areas held by Carr Boyd and Great Boulder or to the other claims near Poseidon which had been the subjects of the announcements of mid-October, 1969. Only a small part of the $2,062,500 raised in the market attending those announcements appears to have been expended in the areas which had done so much to stimulate the market price of Allstate Exploration shares in its rise from 37 cents to $2 in a few weeks.

The Committee has already suggested that a measure of ambiguity as to the date of the Allstate placements was of the essence of the operations: the investing public was not to be informed that it was subscribing new funds to Allstate while it was doing so through the market. A corresponding ambivalence as to the evolving character of Allstate, leaving scope for a mistaken general impression among the public regarding the nature of the need for, and purpose of, the fund raisings, after something had become known of their occurrence, appears also to have been integral to the exercise. This question has had a wider application in the Committee's hearings, and it deserves to be expressed with care.

When the Committee asked Mr Elsworth why his company chose to raise the additional money by way of private placement instead of a public issue with a prospectus, he replied in terms of the need for speed of action to grasp an opportunity in the market rating of Allstate shares. This part of his evidence reads as follows:

Mr Elsworth: To take advantage of the high price of the company's shares at the time, because if we had done it by issue to existing shareholders it would take two months. We could not see what the price of the shares was going to be in two months time, and we thought the shares were so high we would take advantage of that by means of a placement rather than an issue.

Senator Rae: What was the company's need for further capital? Why should it be desirable in the interest of the shareholders to take advantage of the situation which you have indicated?

Mr Elsworth: From the original issue we had in total, including Power Corporation, $650,000. I think about $150,000 was taken up in acquisition of initial leases and in costs of the flotation, meaning we had slightly less than $500,000 in the bank to operate on. We listed with the aim of investigating two particular prospects but also there was this stated aim of undertaking general mineral exploration. The two prospects on which we listed could be investigated with $0.5 million, but there was not much chance of doing very much meaningful general exploration over a continuing period on that amount of money. Therefore, in order to continue over a reasonable period into the future it was a good thing to have more cash in the bank, and when the opportunity arose we took it.

Senator Rae: Was the nature of the market in the latter part of 1969 such as to give you an opportunity which did not exist in the middle of 1969 to raise large amounts of capital and thereby expend the prospective life of the company?

Mr Elsworth: That is right. I think six or eight weeks after we floated, the 10c. paid shares were 8c. This indicates the strength of the market at that time. Six months later it was much stronger.

(Ev. 2551)

No doubt this explanation could be typical of the reasoning behind share placement issues made by a number of other companies in similar circumstances. The Committee has no wish to single out the behaviour of those concerned in one series of placements, but only by examining the details of a case is it possible to illustrate matters relating to placement issues which the Committee regards as important. The foregoing narrative indicates why speed was essential at this juncture of Allstate's affairs: it was because the directors had recently taken steps which suddenly brought the company into the swing of the nickel share boom of Spring, 1969. To have issued a prospectus or to have made a rights issue in those heady days would not only have involved delay (if not necessarily as long as two months), with the risk that a transient share market opportunity would disappear. In addition those more formal methods of capital raising could have required the company to give more information about the purposes of the issue than the brief explanations it published on 26 November 1969 and 7 January 1970, which said, respectively that the additional funds would 'finance its expanding exploration programmes' and would 'finance its exploration program'. These terse statements left the Allstate directors uncommitted as to the particular mineral uses to which the $2,062,500 might be put; but in the climate of the time, following Allstate's mid-October announcements of nickel claims and its further statement on 24 November that geological surveys of the nickel claims would begin early in December, the placement share issues were most likely to be associated in the public mind with the company's new involvement in nickel prospecting. Indeed, the quick succession of placement issues could be taken as emphasising the velocity of the new direction which Allstate appeared to be taking. Had this not been the general impression, it is improbable that the second placement issue could have been made at such high prices.

Ultimately, not much of the money appears to have been spent on those claims. The Committee does not, of course, wish to suggest that more money should have been spent on them, in the light of the geological findings. The point it wishes to make, is that not only was the public unaware that it was subscribing any new money to Allstate while it was paying $2 million for additional shares flowing into the market, but also that the public's conception of Allstate's investment character, which had induced investors to pay those high prices and presumably coloured the public's interpretation of the stated purposes of the issues after it did become aware of their occurrence, was a transient conception and bore little relation to subsequent development.

The company's directors could not be expected to know in November 1969 how much money should reasonably be expended on those nickel claims. But their period of not knowing this was expressly the moment chosen in which to raise very large sums. They did not wait for preliminary results from the first magnetic and geo-chemical surveys of the areas before implementing the quick succession of placement issues. Had they waited a matter of a few months, the results of the surveys, when announced to the public would have substantially reduced the prospect of obtaining public money on those terms. The public would then have viewed the likely purposes of the share issues in a different light, and a light more in accordance with subsequent developments in the company.

The fact that the placement issues were made only six months after the company's flotation and prospectus appears to support the inference that some considerations such as these were in the minds of the directors when they chose the timing of the placements. In a discussion of the issues, the present chairman of Allstate, Mr Elsworth, has said in the course of a letter to the Committee:

Our appreciation of the realities of a share placement by a mineral exploration company is that the people taking the placement of shares are either consciously taking a chance on one or more of the company's then-current prospects, or a prospect it may subsequently acquire, developing into a commercial orebody from which they can draw future dividends; or they would be simply indulging in a speculative share market operation in a share the price of which they consider may go higher and which they hope to be able to sell at a profit.

Mr Elsworth also emphasised the general value of the speculative investment impulse and the need for effective catchment of the results of the impulse for the advancement of Australian-owned mineral enterprise. (The text of his letter is reproduced as Committee Document 10-17).

The value and the need are not in dispute. Indeed, the Committee's main concern is for efficiency of investment, but one of the first requisites of market efficiency is a properly distributed state of knowledge on the part of investors and those raising funds for them. It would be an untenable proposition that any and every company directorate should be encouraged to seize fleeting opportunities to maximise the favourable terms on which they raise funds from the public, regardless of the standards of information offered to investors, and when the directors may by their own public statements have briefly fanned the market in their company's shares. In principle, there are no reasons why the standards of mutual confidence established for money raisings from speculative investors should be different from those applying with other kinds of investors. In the case of the Allstate placement, the timing of the placements made so promptly after the company had ostentatiously associated itself with the new glamour nickel stocks could be interpreted as indicating that the company held more positive views on the potential of the new interests than was the case. The alternative interpretation could only be that the company was relating the speed of its fund raising activities to the opportunities of the nickel share boom. It is impossible to say how many members of the public may have taken this interpretation.

10.58

From several aspects, the Allstate placements serve to illustrate a general conclusion that the techniques available in private share issues can be used so as to ensure that investment by the public will not be made on an informed basis. A 'private' issue may become a battle of wits between those arranging it and the public, with the advantages so much stacked in favour of one of the parties that the other party does not know that the battle is proceeding.

Surveys and Mining Limited Places 1.2 million Shares

Surveys and Mining Limited was a major subsidiary of Vam Limited (already described in this chapter) with shareholders' funds at 30 June 1969 of $8.1 million. As with the parent company, Surveys and Mining was listed on the stock exchanges with a large number of shareholders (8,000 in August 1969). Substantial amounts of capital were raised from shareholders and the public. For instance, in one rights issue to shareholders in July 1969, for which Ralph W. King & Yuill was the underwriter, approximately $5.6 million was raised. At about this time, the company's capitalised value on the stock exchanges was about $38 million. Surveys and Mining was also similar to Vam in its frequent release of public announcements concerning the company's exploratory activities, drilling results and project development. The subsequent fate of the company again parallels that of its parent. The provisional liquidator appointed to Vam in February 1971 was also appointed to Surveys and Mining, and the statement of assets and liabilities at 13 December 1971 shows an estimated deficiency of about $5.7 million.

The aspect of Surveys and Mining's affairs about which the Committee sought and obtained information was the placement of 1.2 million shares announced to the stock exchanges on 2 January 1969. In this announcement the company reported that 600,000 of these shares had been placed with Ralph W. King & Yuill at 60 cents each and the balance had been placed with members of the Melbourne, Sydney and Adelaide Stock Exchanges. Our investigations produced evidence on several kinds of abuses not already referred to in the other case studies of this chapter, particularly bearing upon the joint involvement of stockbrokers, financial journalists, and directors of the issuing and associated companies in placement issues.

Although the announcement of the placement was not made to the stock exchanges until 2 January 1969, in fact, on 18 December 1968, Ralph W. King & Yuill as a principal had bought 600,000 of the new shares at 60 cents each. Over the two days preceding the date on which King and Yuill agreed in writing to this purchase, the share price of the existing shares first jumped from 75 cents to 95 cents and then closed at 88 cents on 18 December. So compared with the quoted prices of the existing shares, Ralph W. King & Yuill obtained the new shares at a highly favourable price. In this instance the broking firm did not sell the new shares on the floors of the stock exchanges, but immediately began selling them as a principal at 62 cents a share to over two hundred clients, and by the time the public first heard of the placement the firm had sold 462,900 shares from its holding. In spite of the large watering of capital taking place, the quoted price of Surveys and Mining shares on the stock exchanges held up, and the last sale price on the Sydney Exchange on 31 December, the trading day preceding the announcement of 2 January, was 90 cents. Between 5 and 24 January 1969, King and Yuill sold a further 47,300 shares from the placement to clients at 62 cents, and the balance of 89,800 shares were retained by the firm as the beneficial owner.

We have said that the stock exchange announcement of 2 January 1969 referred to 600,000 of the 1.2 million shares as being placed with other brokers. Our inquiries revealed that this was not an accurate statement of what took place. Three other brokers and two nominee companies of brokers did subscribe for a total of 395,000 shares, but the remaining 205,000 shares were allocated to 36 individuals and companies. Directors and executive officers of the company apparently nominated this select group of people and companies who, from about 18 December onwards, were sent application forms which they were asked to complete and return with cheques for the appropriate amounts calculated at 60 cents a share. In view of the prevailing market price of the shares (about 90 cents) there was, of course, a great incentive to accept the offers, and several recipients of the cheap new shares expressed their recognition of the favours being bestowed upon them in their notes and letters to the company.

Information received from the company showed that among the list of privileged subscribers was a proprietary company (allocated 60,000 shares) owned by the family of the chairman of Surveys and Mining, Mr F.A. Close. Another director of Surveys and Mining, Mr G.E. Rodan, also received 10,000 shares. A director of Yam, Mr W.D. Ackland-Harman, obtained 20,000 shares, Mr J. Glindemann, a director of Vam subsidiary, received 15,300 shares, and Mr W. Abel-Smith, a director of another Vam subsidiary, acquired 2,000 shares. Also included in the list of subscribers were six financial journalists (including one financial editor and some others of senior position) employed on five major daily newspapers which have an influence on both the Sydney and Melbourne share markets. Another subscriber was a regular contributor to the financial pages of a weekly journal (Committee Documents 10-18, 10-19, 10-20). In late 1972 when we first became aware of the involvements of journalists in the Surveys and Mining placement, it was found that a majority of them were no longer in journalism.

The company's documents also disclosed that on 6 January 1969, that is four days after the public announcement saying that all the shares had been placed with members of the stock exchange~ the company had acted upon the recommendation of its public relations officer, Mr J.R. Gibbs, in making the allocations (of 500 or 1,000 shares each) to the journalists. The records also showed that most of the allocations were agreed to personally by the chairman of Surveys and Mining who was also the Yam chairman. In answer to our inquiry as to why he had recommended allocations of the shares to journalists, Mr Gibbs said: 'It is a normal procedure for a Public Relations Officer to suggest that a small allocation of shares in a public issue be offered to Press representatives (who do not necessarily accept such offers)' see Committee Document 10-21. It is hard to escape the conclusion that the deliberate inclusion of the journalists in the placement was designed by the company, first, to stifle possible criticisms of the placement technique which was to continue to be used so frequently by the Vam group of companies and, secondly, to offer the journalists a personal financial incentive to give relatively favourable treatment in their newspapers to the Vam group's stream of stock exchange releases concerning mineral prospects. The Committee does not suggest that all the journalists responded in the way the company presumably hoped they would.

This placement of 1.2 million shares has several other notable features. Technically it was called a 'private' issue and so apparently did not require a prospectus, though in practice some hundreds of members of the public did quickly acquire the shares. In the letter to Surveys and Mining agreeing to buy 600,000 shares in the placement on 18 December 1968, the firm of Ralph W. King & Yuill set terms which seemed to make allowance for the time needed to sell the shares to the public and obtain the funds to pass on to the company, for the firm agreed pay half of the $360,000 owing to Surveys and Mining within 14 days and the balance within 28 days.

Another feature of this placement was the way, with a substantial part of the issue, the directors dispensed with the services of brokers, even though they said publicly that they were placing the shares with members of various stock exchanges. The sale of these new shares was easily accomplished by setting the price at such a low level relative to the market price of the existing shares, that the recipient of the offer could only regard it as containing a substantial gift from the company. Moreover, the scope for realising an immediate profit increased most rapidly immediately following the announcement. On 6 January 1969 the last sale price was 90 cents; on 7 January, $1.18; 10 January, $1.45; 51 January, $2.30; and 10 February, $2.60. That is to say, within one month of the placement to favoured persons at 60 cents per share, the realisable market price had risen to more than four times that figure. And it proceeded to still greater heights, reaching about $4 a share in May 1969.

At this distance in time, it is not easy to reconstruct the mechanics of the process by which this extraordinary boost in the market price for Surveys and Mining shares came about. It was a sharp boost, even by the standards of the time, and was obviously associated with active rumours in market circles and the continuing flow of encouraging statements to the market from the company. For instance, one Press report on 8 January said: 'The Vam group is another attracting a lot of attention lately ... it is becoming a little rumour-prone again. One usually well-informed source has it that Surveys has signed a large copper contract ...'. This comment was by a journalist who received an allocation of shares in the placement but who could not be contacted as he had left the country.

Several disturbing questions arise about the possible relationship between the placement and the subsequent price rise. Three influential groups of subscribers to the placement stood to gain from the market movement; first, several brokers who had retained part or all of the allocations for themselves and who proceeded to realize their profits as the price rose; next~ directors of Surveys and Mining and of other companies in the Vam group who had taken more than 100,000 shares; and thirdly, six representatives of the financial Press who had been brought in most economically by the distribution of a mere 3,500 shares. This combination of interests may well have been regarded by some of those responsible for the arrangements as being a necessary condition, if not by itself a sufficient condition, for a post-placement rise in the market price of the shares, such as did occur. In our view, there is a presumption that, in arranging the placement and setting the terms of it, the directors of Surveys and Mining were influenced by the opportunities which would be provided to them personally to benefit from acquiring the relatively cheap shares. Finally, we repeat, that of the numerous share placement issues made by the Vam group, the Committee has investigated the circumstances only of two issues, which were chosen at random from the series.

Patrick & Company and D.J. Carmichael & Co. Raise $1,065,000 for Carr Boyd Minerals Limited

On 5 May 1969, some months after its incorporation in Western Australia, a prospectus was registered in respect of a public offering by Carr Boyd Minerals Limited of 5.84 million 20-cent shares at a price of 20 cents each. From the prospectus it could be seen that the company's purpose was to raise about $1.17 million for mineral exploration, concentrating especially on the search for nickel deposits, and that the underwriter of the issue was the Sydney stockbroking firm of Patrick & Company (now Patrick Partners). Soon after the successful flotation, the shares were being traded on the Sydney and Perth Exchanges at levels well above the issue price. Just over one year later, on Tuesday 23 June 1970, there was a public announcement that Carr Boyd had placed 'through' Patrick & Company and D.J. Carmichael & Co., members of the Perth Stock Exchange, a total of 300,000 new shares 'at a substantial premium, referable to the current market price. The statement said: 'Application for the listing of the shares, the subject of the placement, will be made later this week'. This statement was issued by the Sydney Exchange at 11.45 a.m. (Eastern Standard Time), and at 5.45 p.m. on the same day the Sydney Exchange released a further announcement from Carr Boyd which read as follows:

We refer to our letter of 22nd instant and to a subsequent telephone conversation with Mr Foldes [a senior officer of the Sydney Exchange]. The Company advises that the placement of shares was negotiated through the course of last week, the arrangements being finally concluded on Friday 19th instant. The placement price was $3.55 per share. The reference in our letter of the 22nd instant to the substantial premium above par value. We sincerely regret if our previous letter has been misconstrued.

B.H. Davidson, Director.

Patrick Nominees Pty Ltd made formal application to Carr Boyd for 200,000 shares at $3.55 a share on 26 June 1970, and three days later Carmichael Nominees Pty Ltd applied for 100,000 shares at the same price. On I July 1970 Carr Boyd informed the exchanges that the two allottees of the 500,000 shares were the brokers' nominee companies, Patrick Nominees (200,000) and Carmichael Nominees (100,000), and on 9 July 1970 these shares were granted quotation.

The Committee's examination of this placement together with the associated share dealings revealed a number of abuses similar to those we have already discussed in this chapter, as well as several variations in the use of placement techniques.

<u>The Role of Patrick & Company</u>

In September 1972, Mr J.A. Keir, a partner of Patrick Partners (formerly Patrick & Company), appeared before the Committee on behalf of the firm and gave evidence in respect of his firm's dealings in the Carr Boyd placement. At that hearing Mr Keir sought an opportunity to investigate further some aspects of the placement, and his firm supplied additional information in a letter to the Committee of 13 October 1972 (Committee Document 10-22). In the following discussion the Committee draws upon both Mr Keir's testimony and his subsequent letter.

Mr Keir informed us that the day on which Patrick & Company agreed to place 200,000 new shares for Carr Boyd was 17 June 1970. On that day the issue price was arranged at $3.50 a share, but the next day it was raised to $3.55, from which Carr Boyd was to pay brokerage to Patrick & Company. Mr Keir also explained how an additional 100,000 shares came to be included in the placement to make the total of 300,000 shares.

> The additional 100,000 were never offered to Patrick Partners. The company has informed me that they were introduced only when Messrs D.J. Carmichael & Co. of Perth made representations to the company on the 19th June that they be allowed to participate in the placement, they having been closely involved with Patricks when the company's shares were first floated. The company then, on the 19th June, decided to increase their requirement to 300,000 and made the entire additional amount of 100,000 available to Carmichaels.
>
> (Committee Document 10-22)

Mr Keir's evidence again highlights the difficulty of giving a placement any definite date. As far as the firm of Patrick & Company was concerned, it believed it had a contractual arrangement for the placement of 200,000 shares on 17 June, though one which could still be slightly altered the next day in respect of the placement price, whereas Carr Boyd's second public announcement of the placement of the full 300,000 shares on 23 June referred to the arrangements being negotiated 'through the course' of the week ending 19 June and 'formally concluded' on 19 June. The Carr Boyd placement also illustrates the difficulties of relying upon documents as the basis for firmly dating these placements. When Mr Keir was asked if there were records of the arrangement of 17 June 1970, he replied 'I could not be sure. There may not have been correspondence. There could easily have been a telephone call. But there may be correspondence, and I am looking for it' (Ev. 2639). Mr Keir was unable to locate any correspondence confirming this arrangement, but in his letter to the Committee of 15 October 1972 he said: 'Research has shown that, as between Carr Boyd Minerals and Patrick Partners, Carr Boyd agreed, firm, on the 17th of June to issue to Patrick Partners, acting as brokers for Mining Traders Limited and Castlereagh Securities Limited, 200,000 shares'.

On the basis of this arrangement of 17 June, Patrick & Company immediately began large-scale selling of the Carr Boyd shares to come from the placement through its Trading Account (number 41): 64,900 shares were sold at prices between $4.30 and $4.60 on 17 June, 25,000 at prices between $4.40 and $4.70 on 18 June, and 16,200 at prices between $4.00 and $4.45 on 19 June. The shares were sold on the floor of the Sydney Stock Exchange and also through the firm's Melbourne agent, who was a member of the Melbourne Stock Exchange. Mr Keir explained that these sales totalling 106,100 shares were for the partnership's closely associated share-trading companies, Mining Traders Limited (now

Patrick Corporation Limited) and Castlereagh Securities, which were to be the recipients of the entire placement of 200,000 shares made through Patrick & Company. In the records made available to the Committee there was nothing to show that Patrick & Company's Trading Account was being used on behalf of the two share-trading companies (Ev. 2638), and Mr Keir himself was unable to throw much light on why the Trading Account was used in this way: 'I cannot offer an explanation at this time as to why it was done through 41. I think it was convenience, more than anything. I do not know. I cannot offer an explanation' (Ev. 2638).

On Monday, 22 June 1970 Carr Boyd wrote to the Sydney Stock Exchange to tell them of the placement, and the next morning, 23 June, this letter was received and its contents immediately made public. On 22 June, however, Patrick & Company had sold through their Trading Account a further 43,900 placement shares. So by the time the public first learned of this issue on 23 June, 150,000 of the 200,000 new shares had already been sold on the floors of the Australian stock exchanges and to Patrick's clients for a profit of about $140,000 to the broker's two associated share-trading companies.

Mr Keir informed us that he could not recall any discussion with Carr Boyd about the stock exchanges' List Requirements which call for listed companies to disclose immediately 'any alteration of the issued securities of the company and particulars thereof' as well as 'any information necessary to avoid the establishment of a false market in the company's securities'. However, Mr Keir agreed that these requirements were relevant to the Cart Boyd placement. Mr Keir also said that there had been no arrangement between Patrick & Company and Carr Boyd whereby the company would delay the public announcement until after Patrick & Company had been able to sell the shares on the market (Ev. 2646); and later, in commenting on the same point in a letter to the Committee, he said 'the understanding was to the contrary, but it was for the company to make the announcement, not Patricks' (Committee Document 10-22).

In our view it is unsatisfactory that a broking firm should explain its exploitation of an uninformed market by pointing out that the responsibility for informing the market rested with the issuing company and not with the broker. It would be difficult to believe that when the principals of Patrick & Company were disposing of the large quantities of new, unquoted Carr Boyd shares between 17 and 22 June on behalf of their associated companies, they were not aware of the delay in the announcement of the placement and the unfair advantage this gave them in their dealings with their clients and other investors who were not informed that they were buying new shares.

One of the company clients of the Patrick broking firm which was dealing in Carr Boyd shares at about the time of the placement was Mineral Securities Australia Limited, the public company established by Messrs Kenneth McMahon and T.A. Nestel, and on 22 June Mineral Securities bought through Patrick & Company 80,000 Carr Boyd shares. When investigating this transaction the Committee was concerned with two questions, first, whether the broking firm had been acting as an agent or as a principal, and secondly, whether any of the shares sold to Mineral Securities were the new placement shares.

In respect of the first question, the contract notes covering the transaction showed Patrick & Company had acted as an agent, charging $4,127.50 as brokerage. However, the firm's scrip ledger showed that the seller of the shares had been the broking firm's Trading Account (number 41) which, in the face of it, suggested the firm had been acting as a principal (Committee Document 10-23). When this matter was raised with Mr Keir, he said the firm had not sold the shares as a principal. What had happened, according to him, was that the Trading Account had been used to sell some new Carr Boyd shares on behalf of the broker's associates (referred to below) and, in addition, had been used to buy some existing Carr Boyd shares in the market before they were 'booked' to Mineral Securities at the same price as they had cost. This explanation prompted the Committee to ask why the broker's Trading Account had intervened in the transactions involving the market purchases. Mr Keir said in reply that it was 'only to square the situation' and that 'unfortunately, the operators had a tendency to use it as a bit of a pot to put shares in and take them out' (Ev. 2641). Subsequently Mr Keir said that he thought the Trading Account was used 'simply so that one booking would go across, not a number of them. But that, once again, is hard to answer definitely at this point of time' (Ev. 2642). Later in this section we have some comments to make on the firm's use of the Trading Account.

In respect of the second question, it was established that Patrick & Company did sell to Mineral Securities some of the new shares before the announcement was made of the placement on 23 June.

When the Committee called upon Mr Nestel, as the former managing director of Mineral Securities, to give evidence on these Cart Boyd dealings, he said he could not recollect being aware of the fact that his company had been buying placement shares (Ev. 2631). When asked whether it would have affected his decision to purchase if he 'had known that there was a substantial placement being made at the time' Mr Nestel replied:

It would have affected our decision. My memory is a bit loose, and I think you appreciate that in quite a few of these I was not personally involved, so possibly other people would have a better recollection. But I know that this aspect, which extended into one or two others, became a most irritating situation where, in fact, it appeared possible that clients of brokers were purchasing what turned out to be placement shares.

(Ev. 2631)

There can be no doubt that it is important for investors to know at once when a company has decided to make an issue of new shares, and this is why the A.A.S.E. List Requirements insist upon the immediate disclosure of such information. As we believe the firm of Patrick & Company must have known on 22 June 1970 that an announcement of the Cart Boyd placement had still not been made, we are unable to understand how the firm could have believed it was properly meeting its obligations as a broker in implementing a client's order on that day in the uninformed market. The Committee must also note the conflict of interests faced by the partners of the Patrick broking firm when carrying out that order. On the one hand, and most importantly, it was the broking firm's obligation to offer objective, disinterested advice to Mineral Securities on the Carr Boyd share market on that date. Conflicting with this responsibility, however, was the fact that two share-trading companies of which the senior partner of the broking firm was a key director, and in which the firm had substantial interests, were wanting to dispose of the placement shares on the market for a quick, substantial profit. Judging by the volume of sales and the speed with which they took place, these associated companies were not unaware of the advantages in selling before the public announcement of the new issue. As Mr Keir said: 'The market, after the announcement of a placement, quite often retracts because they think there is a large line of stock going to come on to it' (Ev. 2626). The record shows that the conflict of interests faced by Patrick & Company was resolved in favour of the broking firm's associated companies.

Short Sales or Pre-placement Sales

Although Mr Keir agreed with the Committee that 'the public was not aware of the placement at the time the shares were sold' (Ev. 2640), he seemed at first to be confused as to the nature of the sales made between 17 and 22 June by the firm's two affiliated companies. When the Committee suggested that the shares 'were sold to the public without the public knowing that those shares existed', he replied, 'I do not think I can agree with that'. Mr Kelt's reason was that 'they were not specific shares' (Ev. 2639). These comments raise the question of' whether the sales could be regarded as a form of 'short-selling' of existing quoted shares and, before returning to Mr Keir's argument, we wish to draw a distinction between short-selling and the practice of pre-selling placement issues.

In the case of a short sale, a person sells a parcel of shares in a company in the expectation of being able to buy a similar quantity of the shares in the same company at a later date at a lower price. But the seller has no assurance that the price at which he can buy the shares will be lower than the earlier sale price; he might misjudge the market and be forced to cover the sale at a higher price, and so incur a loss. His assessment of the factors affecting the market in the shares should be based upon public information, not upon special knowledge of, say, a company's intention to increase its issued share capital. To use the language of the market, with a short sale the seller is 'at risk'.

However, a person who pre-sells a placement issue at a certain price knows that he will be buying new shares at a lower price which he will then deliver to the purchasers. He does not, therefore, regard himself 'at risk'. Having made this distinction, however, we must add that, when looking at a broker's records, it may be difficult to tell with certainty whether a broker was short-selling or pre-selling a placement. For example, a broker may sell a large number of shares in a listed company as soon as he has arranged to buy new shares of the same class in that company, and it may be his intention to deliver the new shares to meet his obligations under the earlier sales. But at a subsequent date the broker might elect to cover the sales not from the placement shares (which would have to be retained or sold elsewhere), but from purchases of existing quoted shares in the market. One would expect the latter step to be taken only when the market price of the existing quoted shares had fallen to the level of the purchase price of the new shares. Either method of covering the earlier sales would result in a profit. However, the subsequent interpretation of the nature of the sales could easily vary with the method of covering chosen. If the broker's records showed that the sales were covered by market purchases of existing quoted shares, the first selling transactions might be described as 'short sales'. On the other hand, if the sales were covered by the purchases of new shares from the placement, that would suggest pre-placement selling.

In the case of Patrick & Company's sales of Carr Boyd shares on and after 17 June 1970, Mr Keir himself said that the transactions were not short sales, his reason being that the firm had arranged to buy new shares in a placement before it made the sales (Ev. 2659-40 and 2645). However, by the same token, this means that the sales were made in anticipation of the placement. Although at first Mr Keir did not accept this conclusion (Ev. 2640), he subsequently said that the transactions were made 'in anticipation of being able to receive listed shares from the company at a future date' (Ev. 2643).

The Multiple Roles of Patrick & Company Trading Account

Mr Keir informed the Committee that his firm's Trading Account was used for several purposes (Ev. 2620-22): for buying shares as a principal in the expectation of selling them overseas at higher prices; for selling shares overseas in the expectation of subsequently buying them at lower prices in Australia, and for trading in the Australian markets. When it was used for these activities, the account could be regarded as having acted in the way its name implies. But the account also had other uses. Mr Keir said it was used 'as a repository for operating and booking errors, where the operator has bought or sold the wrong stock on behalf of a client' (Ev. 2620). In addition to these functions the account was used to carry our share-trading activities not only for Patrick & Company, the broking partnership, but for public and proprietary companies closely associated with the partners. These selling and purchasing transactions were recorded temporarily in the broking firm's trading account before entries were made to show that the sales or purchases had been made on account of the associated companies concerned.

The Trading Account was also used as a 'clearing account' when the firm had, say, large buying orders from clients and found it expedient to enter the purchases temporarily as purchases by the Trading Account before subsequently allocating the transactions to clients. These allocations and the appropriate book-keeping entries were sometimes made at the close of a day's trading, and they were sometimes made several days later.

An examination of the dealings in Carr Boyd shares leading up to the placement provides an example of the way the Trading Account was used first in one capacity and then in another, and then finally used in two capacities concurrently while the firm was achieving its objective of unloading a large quantity of new shares on the unsuspecting market.

Between 29 May 1970 and 17 June 1970, when the Carr Boyd share price rose from approximately $2.50 to about $4.50 on rising turnover, Trading Account 41 was actively buying relatively large quantities of the shares and selling them in smaller amounts at higher prices. According to the entries in the firm's scrip ledger (Committee Document 10-24), approximately 18 purchases took place on nine days, and there were about 49 sales on ten days. Mr Keir told us That 'the total number of shares bought by [Trading Account] 41 during that period amounted to 52,400 and the total number sold amounted to 32,400'. He said: 'By far the largest percentage of these, namely 27,000 were transactions with or on behalf of overseas brokers and the margin taken on these transactions would represent our commission and transaction duty' (Committee Document 10-25). So during the period preceding the placement, Account 41 was energetically used as a trading account. We may also note that its transactions were sizeable in comparison with the reported sales in Sydney of about 280,000 shares, and by adding to the level of activity in the market at that time the dealings of the Trading Account may have given some impetus to the rising price.

Then, on 17 June, Account 41 abruptly ceased its trading in the existing Carr Boyd shares. No further significant purchases or sales were made until 22 June. But, as we have already related, beginning on 17 June, Account 41 became a large seller of the new and, as yet, unquoted Cart Boyd shares which the company had agreed to make available at a favourable price of $5.50 a share. These new shares were released into the market in numerous transactions on behalf of two of the broking firm's associated share-trading companies which had been allocated the placement shares. As the true significance of these sales was hidden from the market, observers would have believed that Patricks was engaging in large but routine dealing in Cart Boyd's existing shares. All the sales for Mining Traders and

Castlereagh over the four trading days between 17 and 22 June 1970 were booked as sales by the Trading Account. Not until 22 June were there entries posted recording the sales of these shares by the two companies, and the actual entries then appeared as sales by the two associated companies to the Trading Account. In this instance~ an average sale price was calculated based on all the sales of new shares recorded in the Trading Account, and the sales by each company to the Trading Account were entered at this average price.

Finally, on 22 June, while still disposing of some of these new shares, Account 41 was used to buy some existing quoted Carr Boyd shares for which one of the broking firm's clients had placed an order. These shares were apparently held temporarily in the Trading Account before being 'booked' to the client.

One of the main points the Committee wishes to make in this analysis is that not only can a broker's house-trading account be used for various purposes at the same time in shares of the one company, but that after the event it may be almost impossible to determine into which category various transactions belong or why certain dealings took place at all. For example, the Trading Account was frequently used for carrying out arbitrage between the London and Australian markets, as well as for accumulating shares in respect of orders received from London buyers. But Mr Keir said it would be 'very hard at this point of time to identify which was in fact arbitrage and which was London-generated business' (Ev. 2622). In another instance, when the Committee asked Mr Keir if he could find out why the Trading Account had been used in the sales of the new Carr Boyd shares before the announcement he said: 'I think that will be extremely difficult to do because there will not be any documentary evidence' (Ev. 2644).

Another aspect of these Trading Account records which obscured attempts to understand them was that the entries in the scrip ledger were often not made in time order, so that one could not infer that one transaction preceded another simply because it appeared first in the scrip ledger. For instance, it seemed to us after looking at the scrip ledger that the Trading Account might have been used to sell existing Carr Boyd shares to a client on 22 June before these shares were bought in the market for the Trading Account. If this were so the Trading Account could not have been described as having accumulated temporarily the purchases before allocating them to the client, and the broker would have appeared to have been selling the shares as a principal. However, according to Mr Keir, the time order of the transactions was the reverse to what the scrip ledger indicated, and he said it was 'very misleading the way it is produced on the card [scrip ledger]' (Ev. 2642).

This evidence of the complexities of a broker's house account and the difficulties of unravelling the various transactions - difficulties apparently faced as much by stockbrokers as by outside investigators - suggests that any effective regulation and policing of such accounts will require, as a pre-condition, a far more orderly method of documentation and an appropriate segregation of transactions to show precisely into which category the dealings fall.

The Role of D.J. Carmichael & Co.

As we have already shown, of the placement issue of 300,000 20-cent shares made by Carr Boyd Minerals N.L. in June 1970, one-third was taken by one of the largest Perth stock-broking firms, D.J. Carmichael & Co. The placement price of $3.55 was the same as that paid for the remainder of the issue by Patrick & Company in Sydney. The firm of Carmichael had dealt directly with directors of Cart Boyd in the matter and in these verbal discussions the company had quoted $5.55 as the predetermined price, and Carmichael accepted it without having had consultations with Patrick & Company, according to evidence received by the Committee. All of the 100,000 shares were to be taken by the Carmichael firm itself, through a nominee company, Carmichael Nominees. The clients of this firm were given no opportunity to acquire any of the shares at the issue price.

The verbal arrangements were completed and confirmed on Friday, 19 June 1970. On the next trading day, Monday 22 June 1970, D.J. Carmichael & Co. sold 58,300 Carr Boyd shares, or 58 per cent of its anticipated allotment, at prices ranging from $4.70 to $4.85. Some of these sales took place on the floor of the Perth Stock Exchange, but most of them were to members of the Melbourne and Sydney Stock Exchanges (Ev. 2491). D.J. Carmichael & Co. did not tell these purchasers that they were buying new shares, and, as we have previously noted, the company's announcement regarding the placement was not made until the following day, 25 June at 11.45 a.m. Thus before the market was informed of the company's decision to increase its issued capital, the Carmichael firm sold on the exchanges a substantial number of the new shares to be issued.

On the day of the announcement, 25 June, Carmichael sold a further 36,900 Carr Boyd shares at prices which opened at $4.70 and closed at $4.45. Three-quarters of the firm's allocation had now been sold, and the remainder was disposed of in more leisurely fashion over the next four trading days at prices drifting down to about $4.00. So by the time Carmichael came to write to Carr Boyd on 29 June applying for the allotment of 100,000 new shares, most of them had already been sold.

When formally applying to Carr Boyd for the 100,000 new shares on 29 June, Carmichael stated, as a condition of the agreement. 'That the shares applied for by us will not be offered to the public in breach of section 43 of the Companies Act 1961-66 of the State of Western Australia'. This undertaking was apparently given to release the company from the obligation to issue a prospectus, as is required in public issues. Although the broker's nominee company was formally allotted the new shares and paid for them, in practice, as we have seen, this nominee company was used only as a conduit for passing the shares on to the public. In performing this function the broking firm captured a profit of $80,958 in the six trading days beginning on 22 June. It was a substantial return for a very brief outlay of $135,000, made in such a manner as practically to ensure a profit to the brokers.

Two years later, in June 1972, the Committee heard evidence from two partners of Carmichael, Mr Donald George Maloney, the senior partner and a member of the committee of the Perth Stock Exchange and Mr Kenneth Walter Court. They referred to the arrangements the firm had made with Carr Boyd as 'just a normal commercial placement' of a kind which was 'quite common' at the time (Evo 2495). Mr Maloney said: 'I think it happened a tremendous amount during those boom conditions' (Ev. 2498). Both witnesses said that the practice followed in the Carr Boyd case was not contrary to any stock exchange regulation. It had not been questioned by any stock exchange or State authority. However, these Carmichael partners appeared to be conscious of the objectionable features of such private placements, and Mr Court said: 'It is certainly not the practice now to deal in unquoted securities in a listed company before they are given quotation by the Exchange' (Ev. 2498). This comment seems to be another example of how members of the stock exchanges, including members from influential firms, can be out of touch with events taking place in the markets they are themselves dealing in daily and also meant to be regulating. For as we show elsewhere in this chapter, on many occasions in 1971 and 1972, and within two months of Mr Court's expressing his opinion, one of the largest industrial companies listed on the Perth Exchange, Swan Brewery, was carrying out private placements and the brokers selling these shares were engaged in just the type of practice that Mr Court asserted was no longer taking place.

Some of the sales of the new Carr Boyd shares by Carmichael were to the firm's own clients and some to other broking houses. A direct test sampling undertaken by the Committee of the sales made to Carmichael clients showed that although the firm was acting as a principal in these dealings it also charged the clients brokerage commission as though it were an agent, and did not give any indication to the clients on the contract notes or otherwise that they were dealing with the firm as the other principal in the transactions. When questioned about this failure to comply with stock exchange rules, the partners of Carmichael told the Committee that it was caused by the introduction of a new system which was not set up to differentiate for principal-type contract notes at the period in question, though it had since been adapted to do that. When asked whether they had corrected the wrongful charging of brokerage by making subsequent refunds to the clients, they said that the firm had not done so. (Ev. 2492).

Concluding Comments

A notable feature of the placement of 300,000 Carr Boyd shares is the way its organisation virtually ensured a substantial profit to the brokers or their associated share-trading companies. The issue price of the new shares ($3.55 a share) was considerably below the market price of the existing quoted shares of the company, as though allowing for a possible weakening in price which could ensue if it were intended that the new shares would enter the market after the public announcement; so that when the brokers began the sale of the new shares on the uninformed market at prices between about $4.00 and $4.80, they captured large profits. As the evidence shows, in the case of that part of the placement reported to have been made 'through' D.J. Carmichael & Co., the shares were bought by the broker as principal, so that the profits obtained from their disposal into the hands of the public were realised entirely by the broking firm itself. In the case of the other part of the placement, Patrick & Company allocated the shares to two closely associated share-trading companies which in turn received the profits from their prompt sale through the broking firm.

Another aspect of this placement which distinguished it from others is the involvement of two leading broking firms operating from different cities. Acting before any public announcement, the Sydney broker first unloaded most of the portion of The placement taken by its share-trading associates largely on the Sydney and Melbourne exchanges, after which the Perth broker began its disposal of the new shares mainly on the Perth and Melbourne markets. The Committee has no evidence which points to these transactions being deliberately co-ordinated, but their effect, nevertheless, was to mislead investors and create a false market in Carr Boyd shares for at least four trading days, with the instructions initiating the transactions coming first from a group associated with a member of one exchange and then from a member of another exchange. On 17 June 1970, Patrick & Company's sales of the new shares through Trading Account (number 41) accounted for 58 per cent of the gross combined sales of the Sydney and Melbourne Exchanges, and over the three days 17 to 19 June the proportion was 35 per cent. On Monday, 22 June, the sales by Patricks and Carmichael in anticipation of the placement shares amounted to 36 per cent of the gross combined sales reported by the Sydney, Melbourne and Perth Exchanges. It seems extraordinary that three stock exchange committees should collectively either not have known of the extent of this selling of new, unquoted scrip taking place by their own members and associates in advance of the company's public statement or, if they did know, have done nothing about it. This method of introducing distortions to a market from two different jurisdictional areas emphasises the need for a national regulatory body in Australia and is a matter we refer to in the concluding section of the chapter.

Two Placements by Leighton Contractors Limited Raise $900,000

In a letter to the Melbourne Stock Exchange on 23 October 1970, Leighton Contractors Limited began by referring to the clause in the A.A.S.E. List Requirements which calls for the immediate notification of 'any alteration of the issued securities of the company and particulars thereof'. The letter went on to say that 'this day' the company had made two separate placements totalling 500,000 fully paid ordinary shares of 50 cents each 'through' two broking firms at a price of $1.80 a share from which 'brokerage and other charges' were to be deducted. The company stated that 250,000 shares have been placed by John N. Robertson, Thompson & Co., and 250,000 shares have been placed by A.C. Goode & Co.'. The Committee called for the records of both broking firms covering these placements, and also for correspondence and documents from Leighton Contractors.

The Role of A.C. Goode & Co.

The references in the public announcement of 23 October 1970 to the shares having been placed 'through' and 'by' the brokers, and the statement that 'brokerage and other charges' were to be deducted from the proceeds suggested that the two broking firms were not purchasing the shares themselves but were arranging for others to buy them from the company. The records of A.C. Goode & Co. confirmed that this firm did not purchase any of the shares itself; instead, applications were solicited from a number of the firm's clients who then applied to Leighton Contractors for the 250,000 shares, the application forms being collected by A.C. Goode & Co. and forwarded to the company together with the clients' remittances. The price for each share was $1.80, as set out in the public announcement, and the company subsequently paid to A.C. Goode & Co. an amount of 5 cents a share, this sum being described by A.C. Goode & Co. as the 'Underwriting and Placement Fee'. In correspondence with the Committee (see Committee Document 10-26) the firm of A.C. Goode & Co. said that they regarded their role in this placement as an underwriter, in effect guaranteeing applications for all the 250,000 shares.

The time sequence in which these arrangements were completed was as follows. On 21 October 1970, A.C. Goode & Co. wrote to Leighton Contractors setting out the terms on which the placement would be made. On and after that date A.C. Goode & Co. wrote to selected clients advising them to complete application forms for the new shares and return these together with the application money. On 25 October the public announcement of the issue was made. On 4 November, A.C. Goode & Co. sent the applications and remittances to Leighton Contractors, and subsequently the clients were allotted the shares. In our view, this placement was properly organised as far as the timing of the public announcement was concerned. Assuming A.C. Goode & Co's letter of 21 October 1970 was received by Leighton Contractors on 23 October, the company acted correctly in informing the exchange as soon as it had a firm undertaking from the broking firm that applications would be received for the 250,000 shares. Also, A.C. Goode & Co. correctly advised the purchasers of the nature of the shares they were buying, and these purchasers were told they had to apply to the company for the shares, sending their application money with the application, before an allotment would proceed. There was no evidence of these new shares being sold by the subscribers either before the public announcement or before quotation was granted by the stock exchange. Moreover, there was no evidence of either the broking firm or its clients selling the existing Leighton shares before the announcement. It is true that negotiations began between the broker and its clients on the possibility of a placement several days before the public announcement, but some such negotiations must be permitted among issuing companies, brokers, and their major clients before a placement can be agreed upon. The important point is that once an agreement is reached the public must be immediately informed.

One of the questions asked of A.C. Goode & Co. by the Committee was: 'Would you please advise what was the first day on which, in your opinion, your clients were able to deal in the placement shares'. We quote the firm's reply:

You enquire as to the first day on which, in our opinion, our clients were able to deal in the 'placement shares'. We assume by this you mean the Leighton Contractors Limited shares; these were first listed by the Stock Exchange of Melbourne Limited on 17th December 1970, and could not previously have been dealt in by a member of, or a shareholder through, the Stock Exchange.

(Committee Document 10-26)

Subsequently A.C. Goode & Co. advised us that instead of saying the new shares were 'listed' on 17 December 1970, they should have said the new shares were 'quoted' on that date. The especially interesting aspect of the reply is that this firm believes that members of a stock exchange and subscribers to a placement cannot deal through the stock exchange in the new shares until the exchange has granted quotation to the placement scrip.

A feature of this placement by A.C. Goode & Co. which came to our attention was how, once again, the term 'private issue' can cover what many people would regard as a public issue. We have already described how in some placements one or a few applicants have simply acted as conduits for the wide distribution of the shares among investors, so that in effect the private issues have been issues to the public. With the 250,000 shares placed by A.C. Goode & Co., this did not happen. On the other hand, however, even though over fifty of the firm's clients applied for and were allotted the shares, the issue was still regarded as a 'private issue', not requiring a prospectus, on the grounds that it was not made to the public. The question which arises is: How many applicants must there be before a 'private issue' becomes an issue to the public? As with many other aspects of private placements, there is no clear expression of the opinion of the State regulatory authorities on this matter, and the result is that the number of people obtaining shares in some co-called 'private issues' has grown to the point where the issue could only be regarded as an issue to the public.

<u>The Role of John N. Robertson Thom son & Co.</u>

The Committee found that with the placements of two companies in which the firm of Robertson and Thompson was involved the public announcements of the new issues were properly made as soon as the companies had made their arrangements with the brokers. However, in the case of the placement of 250,000 shares in Leighton Contractors, it was found that although the public announcement on 23 October 1970 referred to the placement as being made 'this day', the broking firm's records showed the 250,000 shares as having been bought by the firm's house account on 20 October. When Mr Allen Thompson, partner of John N. Robertson, Thompson & Co., appeared before the Committee in October 1972, he said that 'actually they [the shares] had been sold, as far as Leighton Contractors were concerned, on this date when we bought them as principal' (Ev. 2676).

The broker did not delay in selling these new shares from its house account, and by the close of trading on 22 October 1970, a total of 220,000 shares had been sold: 160,000 to London brokers and the balance to company and individual clients. The firm acted as a principal in these sales, selling the shares at a price which included the minimum profit margin that is set by the stock exchange in circumstances where a broker buys and sells shares as a principal within a period of two days. Although at the time of these dealings the market did not know that a new issue had been made, Mr Thompson said he thought the firm's clients who bought the shares would have been told that they formed part of a placement (Ev. 2676). Mr Thompson was aware of the depressing influence a share placement can have on the market price of a company's existing shares, and he expressed the view that the Leighton placement was one factor giving rise to the fall in the price of Leighton shares following the announcement, which suggests that the broking firm gained an advantage by unloading most of its shares before 25 October.

Two of the firm's clients who purchased 15,500 of these placement shares from Robertson and Thompson at a price of about $1.84 a share on 23 October were also shown in the firm's records as having sold this precise number of existing shares in the company during the six trading days preceding the announcement of the placement. The sales took place at a higher price ($1.97 to $2.00 a share) than the price at which the new shares were bought. On several occasions in our inquiries we were advised that some people with advance knowledge of a placement had sold existing shares in the company in anticipation of buying the cheaper placement shares, and it appeared that some inside-trading of this kind may have occurred with the placement of Leighton shares. However, neither of the two partners from John N. Robertson Thompson & Co. who appeared before the Committee had been present in the firm's office at the time of the negotiations on the

Leighton placement, and they did not know why the clients sold the shares before the placement, nor were they aware of how long the discussions about the issue had been taking place before the announcement. The only information we received about the timing of the discussions was from the firm of A.C. Goode & Co. which negotiated the issue with which it was involved over about seven days before the announcement of 25 October.

The references by Leighton Contractors in its public announcement of 23 October to the 'brokerage' charges it had to pay and to the shares having been placed 'by' the brokers would have suggested to many investors that the two broking firms involved were acting as agents in arranging the placements. However, as we have seen, Robertson and Thompson bought all the shares as a principal. Another difficulty we had in understanding the terms used to describe the role of Robertson and Thompson in this issue was that, in correspondence with the Committee, the firm described itself as an 'underwriter' of the issue. When asked how this was so when there was no evidence of any underwriting arrangement, at least as normally understood, Mr Ernest Alfred Goode, a partner of John N. Robertson, Thompson & Co. said:

On the choice of these words, rightly or wrongly my interpretation is that when a firm goes at risk as principal, it is underwriting it. It is accepting it as principal in making a placement or taking a placement. I do not see any distinguishing factors between the three.

(Ev. 2673)

From the Committee's viewpoint there was little purpose in trying to define the various terms used by brokers such as 'underwriting', 'as principal', 'making a placement' or 'taking a placement'.

The point is that the stock exchange itself has not insisted upon a precise definition of the terms, and the result is that investors and even brokers themselves have been confused about their roles in placements. In the case of the placement of Leighton shares, at no stage was there an unequivocal public statement that Robertson and Thompson on 20 October 1970 had bought the entire placement as a principal, paying a price of $1.76 a share.

A.C. Goode & Co. advised the Committee that at the time of its negotiations with Leighton Contractors it had been told by the company that 250,000 shares were also being placed by John N. Robertson Thompson & Co. However, Mr Thompson said that his firm had not known at the time of A.C. Goode & Co's role, and in evidence to the Committee he expressed some concern at his firm's not having been told of this additional placement of 250,000 shares.

Senator Rae: Would it have affected your decision if you had had any knowledge that the other placement was being made?

Mr Thompson: Yes, it would.

Senator Rae: Do you regard it as something that you would have preferred to have been told by the company?

Mr Thompson: Most certainly.

(Ev. 2677)

Mr Thompson's reasons for believing his firm should have been told of the placement were that it 'was quite an important capital move' which altered the capitalisation of the company and altered its profit return in relation to assets employed (Ev. 2677). Here, then, was an example of a broker, when his own interests were directly involved, readily perceiving various important ways in which a placement had affected a company and in consequence, the market in that company's shares, and expressing indignation that he had not been immediately informed of the decision to make that additional placement. Mr 'i~ompson was not so quick to see why the investing public would have been similarly moved by a sense of injustice - and for the same reasons as those expressed by Mr Thompson - had they subsequently learned that the Robertson and Thompson firm had been dealing in new Leighton shares which it had acquired as a principal on 20 October for several days before the announcement of the issue. After some discussion, however, Mr Thompson did say that there was 'a lot of merit' on the proposition put to him by the Committee that, after a placement has been made, dealing should not take place in those shares until the public has been informed of their issue (Ev. 2678).

Fifteen Placements of The Swan Brewery Company Limited Raises $7.9m

There are a number of distinctive characteristics in the last set of private issues which we investigated without foreknowledge of the likely findings. The issues were handled by the Melbourne broking firm of Guest and Bell, and included a long and rapid sequence of placements made by The Swan Brewery Company Limited of Perth. In these issues the selling of new, unquoted shares, both directly on the market floor and in block sales in advance of any public announcements or formal issuing of the shares was the general and frequent practice of a substantial industrial company over a period extending into the second half of 1972, just prior to the Committee's investigations into the series. Here is an example of the practice occurring regularly in a context removed from the mineral share boom. These issues raise questions about the supervisory standards of two stock exchanges, those of Perth and Melbourne, since the company was directly accountable to the one while the broking firm handling the issues was a member of the other. In this case, moreover, a member of the broking firm was a director of the Swan Brewery

Company. Finally, the issues were channelled to the broker through a peculiarly structured group of associated private companies which are effectively controlled by Swan directors, and channelled in such a way as to bring newly acquired assets into the books of the Swan Brewery at heavily understated values. These matters will now be described in more detail.

Although the continuous history of Swan Brewery placement issues dates back at least as far as 1968 and extends forward into the latter half of 1972, the Committee confined its quantitative study to the issues made during the two financial years, 1970-71 and 1971-72. In that period, the records show Swan as having made fifteen separate non-rights or private issues of its ordinary shares, which have a nominal value of 50 cents each. The sizes of these issues ranged from 700,000 shares to 50,000 shares. The total number so issued in the two years was 5,778,290, from a base of about 34 million shares at the beginning of the period, and the prices paid by those acquiring the shares from Guest and Bell ranged from about $2.40 to $2.05 per share. The proceeds were in excess of $7,900,000.

Each of the fifteen issues was reported briefly to the Perth Stock Exchange as having been made at 'par' to acquire certain assets. The Committee has found that each issue was made in the first place to one or more of a family of three proprietary companies which were closely associated with Swan Brewery, and acted as agents for Swan in the acquisition of assets such as hotels. The proprietary companies then channelled the Swan shares through Guest and Bell for sale or placement on and off the market. In some cases, the issues were made to provide the proprietary companies with funds to make progress payments on building and renovation work which was proceeding.

The directors of Swan Brewery often refer to the trio of proprietary companies under the collective name of 'Glanville'. The registered titles of the companies are A.G. Glanville & Co. Pty Ltd, A.G. Glanville & Co. (N.T.) Pty Ltd, and Lucien & Co. Pty Ltd. In legalistic terms, the companies are apparently not subsidiary or sub-subsidiary companies of Swan, else they would be prohibited from holding shares in the brewery company and from regularly acquiring and selling the brewery company's new placement shares. Their status is nevertheless decidedly that of satellites of Swan, as a glance at their structures will show. The chairman of Swan Brewery, Mr Geoffrey Cohen, is also chairman of all three proprietary companies, while the deputy chairman of Swan, Mr Alan Eric Blanckensee, is a director of all three. The peculiar capital structure of A.G. Glanville & Co. Pty Ltd consists of one share of $2,000 face value, held by The Swan Brewery Co. Ltd and four shares of only one dollar denomination, held by Mr Geoffrey Cohen, Mr A.E. Blanckensee (two shares) and Mr Robert Ernest Blanckensee. Of its total capital of $2,004, therefore, 99.8 per cent is held by Swan, though Swan holds only one-fifth of the shares regarded simply on a numerical basis. In turn, A.G. Glanville & Co. Pty Ltd appears to have a majority of the five $1 shares which make up the capital of A.G. Glanville & Co. (N.T.) Pty Ltd, with Mr Cohen and Mr A.E. Blanckensee acting as the other shareholders in the N.T. company. Next in turn, the $2 issued capital of the third member of the trio, Lucien & Co. Pty Ltd, is held equally by A.G. Glanville & Co. Pty Ltd and A.G. Glanville & Co. (N.T.) Pty Ltd, with one share each. Hence, the effective control and beneficial ownership of the three proprietary companies to which Swan shares are consistently issued in large quantities rests with Swan and its directors.

Distortions of the Balance Sheet

The Committee did not obtain from Swan directors a clear account of the reasons for the construction of the three-layered channel for the issue and disposal on the market of new Swan shares. It notes, however, that one of the consequences of this issuing technique is that Swan itself does not receive any cash proceeds from the share issues, but rather takes into its books real assets passed on by the Glanville intermediaries. This apparently gave the Swan board a feeling of freedom to apply a remarkable accountancy policy towards the newly issued capital and the assets acquired through the intermediaries. In each of the fifteen private issues made in the two years, the evidence indicates that Swan in its accounts treated the shares as though they had been issued at the par price of 50 cents (which was well below the market price of over $2) and brought in the new assets at values correspondingly reduced to a price based on par value for the shares which provided funds for the assets bought. That is, the assets were initially brought into the Swan accounts at less than one-quarter of the cash prices actually paid to contractors or vendors of assets to the Swan Brewery group. In the two years under consideration, the understatement of values of additional assets brought into the balance sheet, by comparison with the going prices actually paid, amounted to about $6,000,000. This was the difference between the book entry of about $ 1.9 million for the assets and the cash proceeds of about $8 million obtained for the issued shares.

Again, the Committee did not succeed in its attempts to obtain a clear expression of the reason for this consistent policy of distortion of asset values in the Swan balance sheet, either in correspondence with Mr Geoffrey Cohen, as chairman of Swan and of the Gtanville companies, or in direct hearings held in Melbourne in October 1972, at which one of the witnesses was Mr Noel Leach Harman, appearing in a dual capacity as a director of Swan and a partner of the broking firm, Guest and Bell. By way of defending the policy, as distinct from explaining the purpose of it, witnesses advanced two arguments: one, that the assets brought into the books at less than a quarter of their current cost were subsequently revalued, and 'bonus' shares issued on the strength of this writing up; two, that the initial understatement of assets on entry did not significantly distort the overall books of a company having accumulated assets on such a scale as Swan Brewery's.

With respect to these arguments, the evidence suggests that the relationship between initial understatement and subsequent revaluing of assets is irregular and uncertain and arbitrary. Both the timing and the extent of the revaluations are left to the discretion of the directors, and are mixed up with the directors' revisions of their desired book valuation for the whole corpus of Swan's accumulated assets from year to year. To take the most recent example available at the time of writing: in Swan's accounting year ending on 28 March 1972, the company had issued 1,977,751 new shares through the Glanville channels, and taken in the associated assets at values about $5,000,000 below the true going cost; but at the end of that accounting year, Swan actually wrote down its total fixed assets by $224,525, in addition to the effective writing down of $5 million just described. Going back to the previous accounting year, ended 50 March 1971, Swan had issued 1,745,000 shares on the usual par-value accounting basis, which meant understating the value of newly acquired assets by about $2.8 million; at the end of that year, Swan wrote up certain assets by $2,219,250 and wrote down others by $84,145. By contrast, in the previous year again (to 51 March 1970), Swan had written up its assets by a net $9.8 million, the result of cumulative adjustments, and made a 'bonus' issue to shareholders.

As regards the significance of the accounting distortions, Swan's gross assets had stood in the books at about $49 million at the beginning of the two year period which we have been considering, while the net excess of assets over liabilities was about $38 million. In relation to that figure an under-valuation by some $6 million of assets newly acquired in the two years can hardly be dismissed as of no importance. This is not the only misleading aspect. The directors of Swan had taken considerable pains not to alert their shareholders or the public to the existence of these under-valuing procedures. As a consequence, shareholders and the public would be bound to form a wrong impression of the meaning of the occasional revaluations and 'bonus' share capitalisationso They would put a positive interpretation upon the 'bonus' issues as evidence of dynamic success rather than regarding them as a partial correction of negative distortions in the company's accounts. The omission from the accounts of any share-premium reserve when in fact the Swan shares channelled through the Glanville group of proprietary companies were being issued at more than four times their par value, like the heavy understatement of new asset values, meant that the new investments were not required to give a realistic account of themselves in terms of earning rate on shareholders' funds. It was left to the discretion of the directors whether or not the new assets would eventually be written up so as to accept that kind of test and discipline, and as to how much. A desire to have this much protective cover or cushioning for their capital investment projects may be the explanation for Swan's practice of par-value accounting.

Given the existence of a motive for understating the values of new assets, the recruitment of one or more intermediary companies of the Glanville type might be held essential to the exercise. If Swan had received directly the money proceeds from its placement-type issues of shares at several times their par value, even momentarily before dispersing the money in payments for new properties, it might have taxed the ingenuity and nerve of any board of directors to bring only a modest fraction of the money into the balance sheet. That no doubt, would be regarded as blatant distortion: what could be done in accounting terms with the bulk of the cash proceeds? Mr Harman told the Committee that the sole function of the

Glanville group of companies was to act in association with Swan in business transactions. This was apparently a case where the bringing in of real assets to the public company's accounts was thought to provide a veil for the values involved which money could not offer. The mere expression of such an idea, however, should be enough to expose the unreasonableness of the distinction. The end-result in Swan's business affairs was the same whether the company took money to acquire immediately certain pre-determined real assets of known cost or whether it went through a formality of avoiding the money in getting the real assets. If it is unthinkable to write down money by more than 75 cents in the dollar, it should be just as unthinkable to write down instantly the new properties which are bought with the money.

The directors of Swan were not required to justify the practice because their shareholders and the public were not informed of what was being done. In correspondence with the Committee, the chairman of Swan has claimed that the value of the acquisitions was correctly stated in the accounts and has quoted references to the valuation procedures which were made in the company's annual reports to shareholders (Mr G. Cohen's letter of 17 November 1972: Committee Documents 10-27 & 10-28). These references certainly did not mention the par-value basis of share issues or the corresponding basis of entering the new assets, and Mr Harman, speaking as a director of Swan in evidence to the Committee, said he could not recall any instance of commentators in newspapers or other publications showing an awareness of the valuation methods being used by the company (Ev. 2689-90). In fact, the procedure seems to have been effectively concealed right up to the time of our investigations.

Before leaving these matters of corporate accounting and turning to questions of irregularities in the securities market which were our original interest in examining the Swan share placements, we must report that we could find no evidence of the company's arbitrary and distorting accountancy procedures being challenged either by the stock exchange authorities or by the auditors of Swan. The auditors have regularly said that the published accounts have given 'a true and fair view Of the state of affairs of the Company and of the group', and in 1973, for instance, the auditors (Cooper Brothers, Goyder & Co.) said: 'We have received the information and explanations we required and are satisfied that the accounts of the subsidiaries, all of which have been consolidated, are in form and content appropriate and proper for the purposes of the preparation of the group accounts'. Thus the auditors who had the specific responsibility of reporting to shareholders on the form and content of the annual financial accounts failed to draw shareholders' attention to the distortions introduced into the balance sheet as the result of the share placement techniques adopted by the directors. Had the Swan Company had to issue a prospectus with any one of its numerous issues it is difficult to see how the auditors would have permitted the directors to disguise from shareholders the true value of the assets which were being bought with the money raised.

The Committee has established that, subsequent to the initiation of its own inquiries into the Swan issues, senior executives of the Perth and Melbourne exchanges held discussions about the issues and reached an opinion that they involved the kind of balance-sheet distortions which we have just described. These discussions took place in September, 1972 (Committee Document 10-29). Whether or not the matter was later taken to the committee level of either stock exchange, there has been no public announcement regarding the Swan issues from either quarter up to the time of the preparation of this Report.

Distortion in the Share Market

In the rapid succession of private share issues made by Swan Brewery in 1970, 1971 and 1972, it was customary for the new shares to be sold either on the floor of the stock exchanges or elsewhere, and to be treated as fully available for such trading before any public announcement was made to indicate that the supply of shares was increased, and sometimes before the shares had even been formally allotted or brought into existence by Swan. As the new shares were invariably allotted to one or more of the Glanville trio of proprietary companies, and the selling on the floor or elsewhere was always done by the brokers, Guest and Bell, this meant that the brokers often sold the Swan shares before the Glanville companies had received them, in confident expectation that the sales would be covered by a supply of new shares. For extended periods, a fairly continuous tap of new brewery shares would flow unseen into the market, and an account of the procedure, given to the Committee by Mr Harman, indicates that the initiatives came from the secretary of the three Glanville companies, Mr D.L. Buchanan, after consultations with Guest and Bell regarding the condition of the share market and its capacity to absorb direct sales of new Swan scrip at the full going market prices, as distinct from the discounted prices at which Guest and Bell would bid for or arrange block sales of the remainder. Mr Harman's account of the procedure, in a letter to the Committee dated 20 November 1972, reads as follows:

1. Mr Buchanan, the senior executive of the three companies concerned, telephones one of our partners indicating that one or more of the companies wishes to raise a certain sum of money by selling Swan Brewery shares. He usually enquires of the ruling market prices and the strength of the market.

2. Using the criteria listed hereunder he decides whether he should sell on the market or request Guest and Bell to bid for the shares (or a combination of both).

a. The estimated number of buyers in the market.

b. The likelihood of those buyers seeking quantity or otherwise.

c. The timespan over which funds are required.

5. If it is considered that there are buyers of significant quantity present in the market and the funds are not required in a hurry, he will usually decide to sell on the market.

4. Having made a decision to sell on the market he issues an instruction accordingly over telex.

5. If the market is thin or the funds are required quickly he may come back to us and request us to bid for the shares, in which event we will assess the risk involved, and if we see fit, bid for the parcel involved at a discount on the market.

6. He will consider our bid, and if he sees fit~ issue instructions accordingly by telex.

(Committee Document 10-50)

As an example of the time lags that these arrangements involved, the Committee discussed with representatives of Guest and Bell an issue of 250,000 new Swan shares, of which allotment was made by Swan's board of directors on 22 December 1970 (Mr Go Cohen's letter of 28 November 1972, Committee Document 10-51). That was also the date of the first announcement of the issue to the Perth Stock Exchange.

Of this allotment, 105,000 shares went to A.G. Glanville and Co. Pty Ltd and 145,000 to Lucien and Co. Pty Ltd. However, the Committee's examination of Guest and Bell's ledger accounts for the Glanville group and of Swan's registry records of that group's shareholdings indicated, first, that Lucien and Co. had begun selling Swan shares in the market through Guest and Bell on 26 November 1970, but that, secondly, Lucien had held no Swan shares from previous issues at that time. The evidence of witnesses confirmed our inference that the anticipatory selling of yet-to-be-issued Swan shares had begun on the market floor some four weeks before the shares were created and any announcement was made to the public regarding them. These on-market sales of unquoted scrip reached a total of 50,000 shares at prices in the range of $2.27 to $2.30 by about 14 December, whereupon Guest and Bell took the remainder of the 250,000 Swan shares for 'placements' with clients at $2.05 each. The last part of the operation was thus accomplished eight days before the allotment and public announcement of the new issue (Ev. 2695-96). Mr Harman, in his subsequent letter to the Committee (dated 20 November 1972) described the circumstances leading to the switch from on-market to off-market sales on Lucien's account. The relevant passage of his letter reads (emphasis added by the Committee):

On or about the 26th November 1970 we were contacted by Lucien & Co. Pty Ltd who advised that <u>they had a parcel of shares for sale</u>. After consultation it was decided that the market conditions applying at the time made it suitable to dispose of these shares on the market until such time as the need for the proceeds became urgent. This firm as brokers for Lucien & Co. Pty Ltd proceeded to act on this order commencing on the 26th November 1970. On or about the 14th December 1970 we were again approached by Lucien & Co. Pty Ltd and advised that the total proceeds would be needed fairly promptly and were requested to bid for the remainder of the parcel, namely 95,000 shares. After consideration we agreed to bid for these shares and negotiated a price to Lucien & Co. Pty Ltd of $2.05 net. We then proceeded to place these shares with our clients. The result of this placement is reflected in our schedule previously submitted.

10.99

As already noted, Lucien did not have 'a parcel of shares for sale' on 26 November or at any time in the subsequent weeks; when an allotment of Swan shares was made to this company in late December they had all been well and truly pre-empted. It appears that the responsible partners of Guest and Bell were in a position to know the full circumstances of this and the other pre-selling operations, since one of them was a director of Swan and presumably aware that no allotment of new shares had been made to the Glanville companies on occasions such as that which has been quoted. It would also appear from the two descriptions of procedure which we have quoted that the policy of those concerned in these operations was to extract as much as possible from an unwitting general public who were induced to subscribe new capital to Swan when they believed they were merely buying existing shares in the market, and that when these possibilities were exhausted special discounts were allowed to clients of this broking firm who took up further shares with a better knowledge of their new character while the general public again continued to trade in Swan shares for a period without knowledge of the increased supply.

In the hearings of witnesses and in correspondence with the brokers and the company, the Committee checked its interpretation of the records in some other sample cases of private issues made by Swan (Ev. 2694-95, 2698-99, and correspondence from Guest and Bell, 20 November 1972, and from Swan Brewery, 28 November 19723 We had found that there was a range of differences in the time-gaps as well as in the size of the private share issues made by Swan in the two years under consideration. Occasions when the new shares were disposed of after the date of allotment and public announcement were comparatively rare. As previously noted, the proceeds from the issues made in this manner through the Glanville group of companies in two years were in the vicinity of $8,000,000. The greater part of the money was obtained from block sales rather than from direct selling in the market. By way of contrast with other case studies in this chapter, we found that the firm of Guest and Bell took note of the stock exchange requirements on the distinction between a broker's roles as principal and as agent, and concerned itself to observe the rules relating to the non-charging of brokerage and the disclosure on contract notes in the cases where the firm acted as a principal. The Committee was told that Guest and Bell whether acting as principals or as brokers in the arrangements, received not less than the equivalent of two-way brokerage commission rates from all the transactions (Ev. 2710). It would appear from this that the broking firm's revenue from the transactions substantially exceeded $200,000 in the period.

In examining the details of one issue, we found partners of the broking firm themselves acting as traders in new Swan shares, and not only receiving a portion of the new issue but also re-selling the shares before the shares had been brought into existence and before any public announcement had been made regarding the issue. In this case, an allotment of 400,000 new shares was made and reported by Swan's board on 8 June 1971, but Guest and Bell had sold the 400,000 shares between 28 and 31 May, and one of the 'clients' to whom they sold was a company Pitlochrie Pty Ltd which was owned entirely by partners of Guest and Bell. Pitlochrie had taken 140,700 of the Swan shares at $2.08 each, plus brokerage. It re-sold all but 700 of the shares in the same period of 28 to 31 May 1971, to overseas brokers at prices between $2.12 and $2.20 (Ev. 2698-99, as modified by Guest and Bell letter of 20 November 1972).

To complete this summary narrative of private issues handled by Guest and Bell, we record that an investigation of the circumstances of issues made by two other companies than Swan Brewery also showed that the sales of the new shares were effected before any announcements were made to the stock exchange. These were issues made in 1970 by Yellow Express Carriers Ltd and by Metramar Minerals Ltd (Ev. 2711).

Defence and Comment

In firmly defending the propriety of the practices which have been described, the senior partner of Guest and Bell, Mr David Hamilton Hume, who is also a committee member of the Stock Exchange of Melbourne, said that they were in accordance with the general custom and the rules of the stock exchange. As justification for the different treatment given to those buyers of new Swan shares to whom they were filtered in the ordinary course of market trading without any indication of increased supply and those clients of Guest and Bell who were allowed to have more information and obtained the shares at concession prices, Mr Hume said: 'It is a question of marketing, I would have thought'. He went on to say that some clients did not seek to know any details when they were telephoned and told his firm had some Swan Brewery shares available, while in other cases, such as institutional clients, 'you might expand on the theme with them' (Ev. 2697). Later, Mr Hume suggested that the four million (approximately) new shares issued privately by Swan in the two years ending June 1972 'is not a huge number' for that company. He also suggested that 'because of common usage, the people who received these shares by and large did know they were capital expansion for the company. But they were not reported until after it was over, which is within the rules of the Stock Exchange' (Ev. 2698). He reiterated this point: 'My understanding is that this ~ normal with placements. They are usually taken by the brokers, and done, completed and finished before they are reported' (Ev. 2711).

The Committee's first comment is that we do not dispute that Guest and Bell is in the company of a considerable number, perhaps a majority, of broking firms who act as underwriters, in following the practice of selling and placing newly issued shares in circumstances where the market and the general public are not informed of what is being done. Our own sampling of private issues, as recorded in this chapter, has yielded a high incidence of such practices.

Secondly, however, neither the practice nor an acceptance of the standards it implies are by any means universal in the securities industry. We find that a number of prominent people in the industry are not aware that the practices exist to any appreciable extent. We have referred to private issues where the broking firms observed the need to have the public informed of the placement before any trading could take place in the new shares. We have also noted another case where members of a broking firm (D.J. Carmichael & Co.) which engaged in the pre-selling practice during the mining share boom expressed an opinion that such practices have since generally ceased and that they had no application in conditions other than those of the mining boom. Yet these same brokers despite their uneasiness at the idea of the practice continuing, also said it was permitted under stock exchange regulations (a question which we discuss in the concluding section of this chapter). In short, there has been insufficient discussion within the industry of the principal involved in this area of activity, and the industry's state of thinking on the matter appears to be primitive and confused, so that the recognised fact that the preliminary arrangements and negotiations for a private placement must necessarily be conducted in conditions of secrecy is blurred and merged into an idea that it should be standard practice for the actual placement and subsequent sale of the new shares on the stock exchanges and elsewhere to be done in similar conditions.

Our third and principal comment is that the degree of frequency of a practice does not establish its propriety. Yet this is the principal defence that the stockbroking industry advanced. It is the closed shop system and the looseness of self-monitoring arrangements in the stock exchanges that have permitted the practices to flourish in so many varieties. In the Committee's opinion, the practices cannot stand the light of day. The secrecy of particular pre-selling operations in the market has only been possible because the public at large has had no idea of the general possibility that they were occurring. If one asks the simple question as to what was the motive for the secrecy of the selling arrangements, the answer is clear: the object was to enable the sellers of the shares to obtain higher prices than they could expect to get if the buyers were aware of the true circumstances - to give advantage to the select few who knew the facts, which means to disadvantage the buyers and the general public. However great the differences in degree, this was the object of the exercises we have described. They were unfair, and they made for inefficiency in the operations of the capital market. With due regard for arguments advanced by witnesses in discussion of the Swan share issues, we do not think it is either a satisfactory or an insignificant matter that a prominent public company having a market capitalised value in excess of $70 million should raise a further $8 million in two years in circumstances of a continually misinformed market in the shares, while the members and some clients of one broking firm were in a privileged position of having information which should have been everyone's by right.

Summary and Conclusion

Summary of Case Studies

On the basis of the evidence in this chapter, there can be little doubt that the stock exchanges have commonly failed even to attempt to enforce those clauses of their List

Requirements which require a listed company to inform the stock exchanges immediately it has arranged to issue new shares. Examples have been given of brokers collaborating with listed companies in the deliberate withholding of this information from the public for periods ranging from a few days to seven weeks. In some instances the delay in the public's knowing of the placement seems to have led to little, if any, distortion in the market. But our inquiries revealed instances where public investors were seriously misled for a large number of trading days, and during these periods there was substantial distortion and manipulation of the share market by stockbrokers and issuing companies. We have shown how directors of listed companies, with the connivance of members of the stock exchanges, have sold large quantities of the new shares on the floors of the main Australian exchanges without the shareholders and the market knowing that the shares were coming on issue and that dealings in these shares were already taking place. In other cases we have shown how members of the stock exchanges themselves secretly arranged to acquire new shares in a placement at a highly favourable price compared with the market price of the existing shares, and then began the large-scale selling of these new shares at a considerable profit on the floor of the exchanges and to clients without the purchasers or the public ever knowing to this day the nature of the shares they were buying. In these placements the market had no awareness that it was dealing with an increased supply of scrip, an increased supply that had not yet been given any formal existence. The market was to be given no knowledge of the increased supply until it had already absorbed the supply. And, again, when the announcement was eventually made, the market was not aware that it had already absorbed the increased supply mentioned in the announcement, so that once more the market was acting on a wrong impression of the supply-demand relationship. The dilution occurred while most investors in the market did not know it was occurring, and there was no dilution at a subsequent stage when the market had reason to assume there would be one affecting the course of sales and prices.

Various devices and subterfuges have been used by stockbrokers and issuing companies to facilitate this disposal of new shares at the highest possible price into the hands of the ill-informed public. One broking firm used its house account to support and manipulate upwards the quoted price of the existing shares on the stock exchanges in order to induce new buyers into the market and so ease the sale of new shares which, unknown to the public, were then sold in the market. These house accounts of brokers have performed many functions. When placement shares have been available for sale, the house accounts have been used not only to 'condition' the local markets in advance of the placement sales or while those sales have been taking place, but also to work in harness with what in effect have been house accounts run in London in order to bring that important market within the general manipulative plan. The orchestration of the two markets has led to apparently high turnover at rising prices, which has then helped to bring forth the greater volume of public orders needed to absorb the large quantities of new shares being filtered undisclosed into the market.

The evidence also shows how a company issued to the stock exchanges a series of 'puffing' statements during the period of the unloading of new shares on to the market, and in one case we found that the company directors had deliberately included six financial journalists in a placement made at a highly favourable price, the circumstances suggesting that this was part of a plan to bring about a sharp post-placement rise in the share price.

In the course of the inquiries evidence was obtained of directors of some issuing companies benefiting substantially from allocations of placement shares made at a price below the market price of the company's existing shares, and we found instances of these new shares being sold at once to the public for a considerable profit. With some private issues, the fact that a director was participating in the placement in this way could have been discovered from the company's public records, but in other instances the extent of a director's involvement was hidden from the shareholders of the issuing company and the investing public. In one case not discussed in this chapter we found that the key director of an issuing company benefited from a placement by having a substantial interest in a proprietary company that obtained relatively cheap shares in the placement and then began selling them in the market. In this instance, however, the director's interest in the proprietary company was not held in his own name but was held in trust for him by another company which was in turn associated with and managed by the broking firm that arranged the placement and carried out the subsequent sales. Our concern with placements of this kind is that there is an obvious conflict between the director's duty to place the new shares at a price which is satisfactory from the company's point of view, and his interest in himself acquiring some of these shares at a relatively cheap price, perhaps for the purposes of immediately selling them at a profit.

While carrying out our investigations of placements, random checks were made of brokers' records to see whether, when acting as principals in share dealing with clients, they followed the stock exchange rules of disclosing their position as principals and not charging brokerage. Our inquiries showed that several influential stock exchange committee members have broken the rules in this respect, and there is no indication that anybody on the executive or elsewhere - except this Committee - ever challenged their misconduct. On several other occasions we also received evidence of firms failing to disclose their dealings as principal and improperly charging their clients brokerage (see, for instance, Committee Documents 10-32 & 10-33). In making this statement we must say that we are aware of the rules of the stock exchanges that specifically require broking firms that buy shares as principals and sell them within two days to obtain a profit margin at least equal to what the brokerage would have been had the firm been acting as an agent (Rule D1 of the Uniform Rules of the A.A.S.E.). In these special circumstances we also found several brokers who failed to disclose their role as principals and sent out normal agency-type contract notes which included a large profit margin plus standard brokerage. The particular rule we have referred to here is designed to stop broking firms acting as principals in order to undercut the minimum rates of brokerage, and it is questionable whether such a rule is desirable in an efficient, competitive securities market.

One of the suggestions made to the Committee was that some brokers have built up lists of favoured clients to whom they allocate relatively cheap placement shares as a means of attracting further broking business. It was alleged that, included in these lists, are managers of large institutions and corporate portfolios who, in return for gaining personally from an allocation of shares at a favourable price, direct more of the institution's or company's business to the broker. We do not know the extent of this practice, but we obtained some documentary evidence to suggest that it does occur. An objectionable aspect of this practice is that it may lead to brokers encouraging placement issues by public companies not so much with regard to the interest of the shareholders of the issuing company, but more with the objective of having relatively cheap shares to distribute to individuals who can, in return, steer to the broker a greater volume of institutional business.

This Committee recognises that if private placements are to be made at all, companies and their agents must be able to enter into negotiations with prospective purchasers in the capital market before any public announcement of an issue. But there can be no doubt that as soon as the company or its agent has reached agreement with the purchasers on the issue, the public should at once be informed. In our view, too, as soon as a broker has agreed with a company to guarantee or underwrite a placement, the public announcement should be made. Moreover, if a broking firm agrees to buy the placement shares itself, the public announcement should not be delayed simply to assist, the firm in selling the shares at a price which will yield it the maximum profit. Having made these comments, however, we must also draw attention to the fact that, during the negotiations of a placement, both the company's agent and the prospective purchasers will have advance information of the company's intention to increase its issued capital. It is unavoidable that some people and companies will have this knowledge, but regulations should be introduced to prevent the prospective purchasers from taking advantage of their advance knowledge by selling their holdings of existing shares in the market (or short-selling existing shares) in anticipation of replacing them with cheaper shares from the placements.

The scope for members of stock exchanges to behave in the ways we have described has, in our view, been greatly widened by their freedom to act not just as advisers to the public, but also as organisers and underwriters of company issues, share traders in their own right and sole arbiters of what companies and shares will be listed and quoted on the stock exchanges. The opportunities for brokers to promote their firms as large underwriters and raisers of new capital are, of course, greatly enhanced by their willingness to act in the ways we have described. In reality however, there is little or no risk for a broking firm as an underwriter of a share issue when it uses its special access to the floors of the stock exchange to sell the new shares behind a smokescreen of routine trading in the company's existing capital. As we have seen, the new shares can even be sold to the unsuspecting public and the funds and profits obtained before there is any need to hand the funds on to the company. To become an underwriter or raiser of capital in such circumstances it is not necessary to have either strong capital resources or the ability to judge the price at which an informed market will pay for the new shares. The basic skill required is to be able to disguise the fact that the shares being sold are different from what they are.

That brokers have been large organisers of private share placements along the lines described in this chapter would seem to have been related to their multiple interests as participants in the share market as well as the main regulators of that market.

Ambiguous and Ineffective Stock Exchange Rules

It has been shown how brokers have sold new shares from a placement before any public announcement of that placement in several ways. The sales have been made on the floors of the stock exchanges of which the brokers have been members, on the floors of other Australian exchanges through their agents, to Australian clients, to overseas clients, to trading accounts run jointly in London with members of the London Exchange, and to overseas brokers. One of the first steps we took in our examination of private issues was to ask the chief executives of the Sydney and Melbourne Exchanges whether their Exchanges allowed placement shares of a listed company to be sold by a broker on the floors of the Exchanges before they were granted quotation. The replies (see Committee Documents 10-34 to 10-57) seemed to indicate a genuine inability on the part of the chief executives to grasp what was meant, at least they skirted round the central question. But Mr D.M. Butcher, General Manager of the Sydney Stock Exchange, did say, almost in passing, that 'a broker either as principal or agent would be debarred from dealing on the floor of the Exchange in securities yet to be granted quotation', as though it was self-evident that such a practice would be stopped. Subsequently, however, several brokers who have sold placement shares in advance of any public announcements informed us that they had traded in the shares on the floors of the Sydney Exchange in the confident belief that the Exchange does not have a specific rule forbidding the practice.

Here, then, is a case where the general manager of an exchange told us that a certain market practice would be 'debarred', whereas other evidence was to reveal how several members of the exchange were frequently involved in the very practice he said would be prohibited. The interesting question arises as to whether, if a chief executive of an exchange had known of the practice, he could, acting alone, have debarred it. However, the chief executives of the main Australian exchanges do not have that power over members of a stock exchange; they would have had to refer the question to their chairmen or committees. So even if the senior stock exchange officers had been aware of the existence of the pre-selling arrangements by stock exchange members, it is highly unlikely that they themselves could have checked the practices. It is also doubtful whether they would have been able to have them abolished by their committees. We have already noted how some stock exchange officials formed a strong suspicion of irregularities in the balance sheet of Swan Brewery arising from the procedures adopted in the private issues, but this has not led to any public statement to prohibit such arrangements. Furthermore, some committee members know of the abuses we have described in this chapter, but they have not taken any action to have them stamped out.

Further inquiries by this Committee into the question of whether the stock exchanges have any rules covering pre-selling of placement shares showed that this is a curiously blurred issue. We found a tendency among some brokers to claim that one regulation which is common to all exchanges carried an implication that such practices were permitted. This regulation reads as follows:

Members are prohibited, either in their office or elsewhere, from making quotations or dealings in a new issue or placement of securities made for the purpose of qualifying the company for admission to the Official List of one or more of the Australian Associated Stock Exchanges, until such securities have been granted official quotation PROVIDED THAT the provisions of this Regulation shall not restrict a Member from disposing of such securities where they comprise an underwriting or sub-underwriting shortfall.

It will be noticed that the prohibition on advance trading relates to 'a new issue or placement of securities made for the purpose of qualifying the company for admission to the official list of one or more Australian stock exchanges'. It does not refer to new issues by companies which are already on the list, such as have been the subjects of the case studies in this chapter. Members of the Perth broking firm of Carmichael & Co. explicitly pointed to this phrasing as evidence that the kind of pre-selling they had made of shares in Carr Boyd Minerals Ltd, even on the market floor, was permitted by the rules (Ev. 2499). Such is the ambiguity of the regulation that this claim cannot be dismissed. There may, indeed, be other possible interpretations of the intention of the regulation which has been quoted: for instance, it might perhaps be suggested that the intention was not to indicate a general exemption for new shares of already listed companies from the ban on pre-selling, but rather to emphasise the special stringency of the prohibition applying to the broker's involvement with the securities of unlisted securities - prohibitions from even 'making quotations' to anybody for such securities, and from doing so 'either in their offices or elsewhere'. But this is conjecture; the regulation does not spell out any comparative set of restrictions relating to brokers' handling of new issues by already listed companies.

In considering these puzzling questions concerning the intention of stock exchange rules which relate to members' dealings in private share issues, we feel that it may be desirable to allow for the possibility that the ambiguity itself suits the intentions of some brokers. The practical effect has been to give them a free rein and, as we have seen, put them in a position of competitive advantage against any other class of potential underwriters and organisers of company issues.

But although the rules of the stock exchanges which apply to their members' dealings in placement shares may be unclear, the rules of the stock exchanges which apply to listed companies seeking quotation of additional shares are, in our view, sufficiently explicit. It appears to the Committee that section 2 of the A.A.S.E. List Requirements, reasonably interpreted, supports the propositions put in the first part of this chapter, that quotation is granted with respect to shares, not classes of shares, and that quotation must be granted by the relevant stock exchange of further issues of shares in a class, some shares in which are already quoted. Accordingly, until this approval is forthcoming, a company making a placement should not expect the additional shares to be traded on the stock exchanges. Presumably that is the reason for the reply by Mr Butcher to the Committee's inquiry. While the Committee expresses no concluded view on the question, it should state that it is not unaware of the possibility that there was, on the part of those who bought the placement shares, such an understanding that they were buying previously and properly quoted shares that the legality of the contracts could be affected.

Although the A.A.S.E. List Requirements state that the directors of a company must notify the appropriate exchange immediately of any alteration of the company's issued securities~ the Australian Associated Stock Exchanges evidently do not allocate the responsibility for ensuring the implementation of this requirement to any members of an exchange who may be handling such an issue of new securities. We were told by a member of the committee of the Stock Exchange of Melbourne, giving evidence in the matter of Swan Brewery's private issues:

It is entirely fair to say that over a number of years we [that is, the members of his broking firm] have understood the implications of these placements, and those of us who care to think about it. I believe~ understand the implications of the types of thing we were talking about at the beginning of this interview. We have taken the view that the method of these placements is not our decision. It is a decision beyond us. We are asked merely to act as broker in it ...

A partner of a Sydney broking firm (that was represented on The committee of the Sydney Exchange for a long period) also said~ when asked about his firm's selling of Carr Boyd shares from a placement before the public announcement:

There was no agreement between Patricks and the company that the necessary announcement to the Stock Exchange would be delayed; the understanding was to the contrary, but it was for the company to make the announcement, not Patricks.

(Committee Document 10-22)

In the Committee's view a member firm of a self-regulatory stock exchange should accept professional or ethical obligations to the market to take action to alert exchange authorities when it becomes aware that the market is not fully informed. For a firm not only to fail to take such action but also to profit from the misinformed market by the sale to it of unquoted scrip is a serious matter.

It should also be mentioned that even though the responsibility for abiding by the A.A.S.E. List Requirements has rested with a listed company, in practice many companies, and especially the smaller and newer ones, have relied on their stockbrokers to advise them of the particular List Requirements which must be fulfilled from time to time. One reason for the ineffectiveness of the List Requirements concerning private issues has been that some brokers have failed to recognise their duty to advise their company clients of the relevant requirements they must fulfil.

This chapter on private issues by public companies provides examples of a contradictory situation which has come to the Committee's notice at several points of its inquiry. While the stock exchanges have taken a considerable measure of responsibility for imposing standards of conduct upon the corporate business world, they have not always been so stringent in upholding standards of practice among their own members, even when members are sometimes actively co-operating in activities which breach the exchanges' listing code for companies. The stock exchanges' quasi-judicial and legislative pretensions are compromised by the interests of their members which conflict with the enforcement of the judicial function. It is hard to see how the exchanges can expect to command the degree of respect of business corporations that is necessary if they are to fulfil such a role.

Are the Practices Widespread?

Our interest in the abuses associated with private issues came about by chance during the latter stages of the Committee's inquiries. As the nature of some of the dealings became apparent with the initial investigations, various other issues were selected at random for examination. It was then found that there were few private issues to which we turned our attention which did not involve what we would regard as undesirable practices. Our reaction was one of astonishment that such practices had not only been going on but had been taking place for so long, unchecked, and had apparently never been mentioned in Press or any other comment. We cannot say how many companies and brokers have been engaging in these activities, as we did not have the resources available for carrying out that kind of survey. With each of the private issues we did look at, a great deal of time extending over many months was required for the collection and analysis of company, brokers' and clients' records. Further time was required in taking oral evidence from the parties concerned and sometimes in conducting a supplementary correspondence with them. We have reached the conclusion, however, that practices of the kind revealed in this chapter have been widespread. Mr K.C. Phillips, a partner of Ralph W. King & Yuill, was of the same view:

Chairman: And also Ralph W. King & Yuill was selling shares the existence of which the market had no knowledge?

Mr Phillips: That is right.

Chairman: So that one of the effects of the sales was to put into circulation on the market a number of shares in excess of the total number of which the market was informed existed?

Mr Phillips: Yes.

Chairman: Was that a common practice in your experience amongst stockbrokers?

Mr Phillips: I would think so, yes.

(<u>in camera</u>)

Although the knowledge of these market practices seems to have been mainly among stockbrokers, some other investors apparently suspected that such dealings were taking place, though they found some difficulty in fully understanding the details of the transactions. For example, Mr T.A. Nestel, the former managing director of Mineral Securities Australia Limited, testified that he knew of the practice, before going on to say: 'At the time we were not quite sure how it in fact was being done'.

In referring to one placement Mr Nestel said:

... For some days they were purchasing shares for trading purposes, and we eventually were tipped off that daily placements were being made and we were not being told of this. We were merely absorbing some portion of the daily placement. These were possibly being sold on the market, which, I think you will appreciate, is a very irritating situation to be in as a trader.

(Ev. 2632)

The Committee could not fail to become interested in the range of states of awareness and ignorance among persons at the heart of the securities market as regards the practices which have been analysed. The variations in degree of understanding are a phenomenon in themselves. On the one hand, some stock exchange committeemen belong to firms which engage in these practices, and are ready to pronounce the practices as widespread. On the other hand, we have encountered exchange committeemen of long experience who obviously possess no knowledge of actual occurrences, though some have a suspicion that there could be such abuses on occasions, and speak with abhorrence of the possibility. We have even recorded an instance where a Perth broker whose firm engaged in these practices during the mineral share boom of 1970 told the Committee confidently that the practices had ceased since that time, even though one of the partners of his firm is a member of the committee of the Perth Stock Exchange and we have established that the practice of pre-placement selling continued under the noses of that exchange well into 1972. As mutual competitors for business, brokers are apparently able to keep the nature of some of their activities effectively concealed from other brokers. The members of stock exchange committees plainly do not draw upon anything like a common pool of knowledge when they sit together to deliberate matters calling for self-regulation by the exchanges.

Those concerned with representing the interests of the public must be disturbed to find that individual brokers who are among the senior members of the stock exchanges should calmly have accepted the continuation of the abuses we have described. This information alone - without the other evidence discussed elsewhere in this Report - would have been sufficient to lead us to the view that there are grave weaknesses in the present method of regulation. If we consider the chief stock exchange authorities - the chairmen - either they have known and failed to prevent or they have not known and failed to discover the deceptive techniques that have been used for raising capital through private issues. In either case, in this Committee's opinion, they have not fulfilled their obligations to the public.

It is equally disturbing that the State government regulatory authorities have not to our knowledge, publicly revealed these market practices, and whatever private action the State authorities may have taken to stop them it has been ineffective. In 1970 the Company Law Advisory Committee in its Fifth Report (pp. 5-6) specifically informed the State authorities of certain weaknesses in their legislation concerning private issues. There was no mention of the numerous abuses which we have since found to be taking place, but attention was drawn to the difficulty in defining the term 'issue to the public'. After first showing that 'no attempt has been made in the Australian legislation to define the term, except in a negative and partial fashion', the Advisory Committee discussed several court decisions and concluded that an 'extension of the scope of the words was obviously needed' and that the present method adopted by the legislature 'leaves much to be desired'. Despite this warning of the need for change in the legislation, no public action has been taken.

In our inquiry we have not thought it part of our function to detail the various legalistic devices by which large capital raisings have been made without prospectuses. We emphasise, however, that many so-called private issues in Australia are in reality issues to the public. Moreover with some of these issues, not only has there been no prospectus by which the market could evaluate the merits of the issue and see the way the funds were to be used, but the market has not known at the time it was being tapped for new capital. In other words, with these issues there was no opportunity for the market to perform what is thought to be one of its main economic functions: to assess carefully the published information on companies and new ventures in order to select those offering the better prospects and so deserving of a greater proportion of the community's real resources. We do not know the amount of capital raised through private issues of different kinds, but it is clearly substantial, and a misallocation of resources has been taking place through some of these placements. We believe many companies have raised capital on terms more favourable than would have been possible had the market been given notice of the issue by a prospectus which informed it of the purpose for which the funds were required, and gave details of the nature of the planned participation of brokers, directors and their associates in the issue.

Why Regulation must be National

There is a final general lesson to be learned concerning the operations of the various regulatory bodies in Australia, and in order to elucidate the discussion we will consider the private issue of shares by Carr Boyd Minerals to D.J. Carmichael & Co. to which we have already referred.

Carr Boyd was registered in New South Wales and listed on most stock exchanges with the home exchange in Sydney. The firm of D.J. Carmichael & Co. is a member of the Perth Exchange, and it sold the new Carr Boyd shares it was to receive in the placement on the Perth Stock Exchange as well as to brokers in Sydney and Melbourne. The various regulatory agencies which could have been concerned with these dealings were, therefore, the State authorities in New South Wales, Western Australia and Victoria, and the Sydney, Perth and Melbourne Stock Exchanges. But each of these regulatory bodies had within its jurisdiction only some of the transactions, so that an inquiry within any one jurisdiction would have given incomplete information on the details of the dealings. Yet unless most of the details concerning the initial arrangement for the placement, the immediate sale of the new shares on the stock exchanges, the timing of the announcement, the subsequent allotment of, and payment for, the new shares, and their eventual stock exchange quotation were brought together for examination, an investigator would probably not have seen clearly how the placement was accomplished through various practices which led to the distortion of the market in Carr Boyd shares. An investigation of this particular placement by any one authority would have been complicated further as the result of a member of the Sydney Stock Exchange obtaining a placement of new Cart Boyd shares at about the same time and immediately selling these shares on the Sydney

Stock Exchange and to a broker who was a member of the Melbourne Exchange. Either there had to be a close and continuous communication between the various regulatory authorities so that, for instance, the Western Australian authorities were constantly following and being told of market events in Sydney and the relationships between activities there and the market in Perth, or one authority such as, say, the Sydney Stock Exchange, had to be exceptionally alert to the possibility of abuse not only within the market under its jurisdiction but also in markets under other jurisdictions, and successful in persuading other exchanges to follow up its initial inquiries and combine in a joint investigation.

In the Committee's view, while there is co-operation on joint investigations once major abuses have come to light, there is not in practice the continuous co-ordinated monitoring of the entire national market which is necessary to reveal and prevent practices of the kind disclosed by our investigation of private placements. The case studies of this chapter provide evidence of not only the breakdown in effective regulation by various stock exchange and State authorities, but also of the intrinsic difficulties of trying to regulate effectively a national share market with a fragmented structure of regulatory bodies.

CHAPTER 11
SOME MARKET PRACTICES IN PUBLIC ISSUES

In earlier chapters of this Report we have referred to various market practices associated with share issues to the public which should be more closely regulated. In particular, in the preceding chapter, we have shown how many so-called 'private' issues have, in reality, been issues to the public and have been associated with practices which should be brought under close supervision. In this chapter we discuss evidence obtained on the public flotation of four companies which were based in Perth, Melbourne and Sydney. The four case studies show that more effective regulation is needed to operate throughout Australia to ensure, firstly, that in the post-issue share market, public investors and stockbrokers' clients are not dealing at a disadvantage relative to the underwriters, sub-underwriters, promoters and directors involved in the issue; secondly, that more consideration is given to providing public investors with a reasonable opportunity of obtaining shares in new issues mad~ on the public market; and thirdly, that investors have better opportunities of arriving at informed decisions when deciding whether to subscribe new capital to a company.

'The Float of the Year' in Perth: An Analysis of a Public Issue

One of the main purposes of this first case-study is to/discuss the methods by which the shares in a 'public' issue for which there was a great and widespread demand came to be distributed to the general public. The flotation which we now analyse to illustrate what we believe to be fairly common practices is that of Australian Consolidated Minerals N.L. Our inquiries revealed that at the same time as the general public was being invited and encouraged to subscribe to this popular issue, a marked tightening of the available supply of shares was taking place through their pre-emption by share-trading companies and people closely associated with the broker-underwriters and by a group described as 'the directors and promoters'. In particular, the broker responsible for the distribution in the eastern States of about 30 per cent of the shares 'offered for public subscription' retained, mostly through nominees, more than 60 per cent of these shares for the benefit of a group of share-trading companies intimately intertwined with the broker's own business. As this information was not disclosed in the prospectus or announced to the stock exchanges, investors did not know that the supply of shares available to the general public in the flotation was being cut back substantially from the amount which they had been led to believe would be offered. Some thousands of investors were either unable to obtain an allotment, or were allocated a smaller number of shares than they desired. In the market climate at the time, and considering the other influences heightening the demand for the shares, the effect of tightening the supply of shares in the flotation was, in our view, to stimulate even further interest in the post-flotation market. The groups which had limited the supply of shares to the general public in the flotation were, as the result of these actions, also in a position to limit or control a substantial supply of the shares in the post-flotation market, and again the market was unaware of this fact. In particular, the general public had no way of knowing that the supply of shares for trading, and for meeting their stimulated and unsatisfied demand, would be significantly influenced by the decisions of broker-dealers who had carried out part of the distribution and who had held back a significant portion of the issue for themselves and their associates for release in the after market.

Our investigations showed that following the quotation of the securities on the exchanges, many of the shares which, in effect, had been withheld from the public in the initial distribution, were released in numerous sales into the market and to the clients of brokers associated with the issue at a great profit to the brokers. These sales accounted for a substantial proportion of market turnover and, in our view, virtually amounted to the re-distribution to the public of many of the original shares which had apparently been offered in the prospectus. Once again, the clients of the brokers who bought some of the shares were not informed of their brokers' interests in the sales. For these reasons the public distribution of the shares of Australian Consolidated Minerals N.L. (ACM) may be regarded as taking place in two linked stages: the first and partial distribution took place while the prospectus was open; the second and final distribution took place during the post-flotation trading at vastly higher prices than the price set out in the prospectus. In both stages of the distribution the stock exchanges permitted the withholding of the information about the factors warping the relationship between supply and demand in the market.

The evidence also provides information on the conflicting roles of underwriters in public flotations, the attitudes of some brokers to such issues, and some ways in which the stock exchanges have failed to ensure that their members fulfil their fiduciary responsibilities when dealing with their clients.

Distribution of the Shares

Who Distributed the Shares

Australian Consolidated Minerals N.L. was incorporated in Western Australia on 10 October 1969, about ten days after the announcement of the phenomenally rich nickel strike by Poseidon at Windarra, and the prospectus was dated 31 October 1969, by which time the Poseidon share boom was well under way. In several respects ACM was different from many of the other new companies which were floated during the boom to engage in nickel exploration in Western Australia. In the first place, ACM was to be closely associated with two established and well regarded mining companies - Metals Exploration N.L. and Freeport of Australia Inc. (a large international company) - which had already proved that they could explore successfully for nickel deposits in Australia. Metals Exploration had discovered and was bringing into production a commercial nickel deposit at Nepean, Western Australia, and it was hopeful of also bringing into production a major nickel deposit at Greenvale, Queensland. Several of the exploration areas referred to in the ACM prospectus were to be worked as joint ventures with Metals Exploration, and the ventures were to be managed by that company. In addition, the prospectus drew special attention to two directors on the ACM board, Mr John Harold Hohnen and Mr Raydon Charles Simpson, pointing out that they were mining engineers who had worked in senior positions with two other established mining companies in Western Australia, Conzinc Riotinto and Gold Mines of Kalgoorlie. The chairman of ACM, Mr Richard Paull Septimus Burr, then a Member of Parliament of Western Australia and described as such in the prospectus, stressed these features of the company in the prospectus and spoke of the intention of establishing offices, appointing a general manager, geologists and a technical staff. He said it was intended to create 'an organisation capable of undertaking comprehensive prospecting and full-scale mining operations' which would be a

... Western Australia based Company having its roots in the vast mineral fields of the Murchison district, and which could compete equally in exploration activities and in mining operations with Overseas and Eastern States organisations attracted here as a result of W.A.'s current mineral boom ...

A further feature of the prospectus which could be expected to encourage subscriptions was that investors were told they could expect some proportion of the call money paid on the shares offered to be an allowable deduction under section 77C of the Income Tax Assessment Act. (An amount of 6.01 cents a share was subsequently declared to be the allowable deduction.)

The size of the ACM issue was $3.4 million, which was large by the standards of most of the flotations of mineral exploration companies. However, the issue was most favourably received by the market, and the underwriters experienced a very large and widespread demand for the shares, requiring severe rationing of the supply among the applicants (Ev. 2502 & 2512). Although 17 million shares at 20 cents each (carrying the rights to 19.5 million options) were offered for subscription, roughly 6.8 million of these shares (carrying the rights to 9.3 million options) were reserved for application by the shareholders in Metals Exploration N.L., Western Queen (1936) No Liability, Mountain View Gold No Liability, and West Coast Holdings Ltd, the four companies which had agreed to sell to ACM various mineral claims and leases for the flotation. The remaining 10,232,700 shares (each share carrying the right to one option) were, according to the prospectus, 'offered for public subscription'. The prospectus also disclosed that on 23 October 1969, two Perth brokers, D. J. Carmichael & Co. and Saw, Cambridge & Brannelly, had 'underwritten and taken firm' the whole issue.

It seemed to the Committee that the expression 'taken firm' would normally be regarded as descriptive of the obligation of the underwriter. We were told, however, that the phrase 'taken firm' had another meaning: it meant that the brokers had the right to nominate the allottees of all the shares reserved for 'public subscription' (Ev. 2501 & 2508). In other words, if the demand for the shares were so high that some applicants would have to be excluded from the issue (as turned out to be the case) the broker-underwriters would decide who would be the successful allottees, and who would miss out. According to one of the underwriters, the expression 'taken firm' means that the underwriters of a so-called 'public' issue may even retain all the shares for themselves, subject only to obtaining a certain minimum number of shareholders to meet the stock exchange listing requirements (Ev. 2508). Towards the end of this section we have some further comments to make on 'public' issues when we suggest that steps be taken to widen the scope for public participation in popular flotations.

Messrs D. G. Maloney and Mr K. W. Court, partners of D. J. Carmichael & Co., informed us that the 10.2 million shares (with accompanying options) which, according to the prospectus, had been reserved for 'public subscription', had been divided among the following brokers for either retention by the firms concerned or for further distribution: Patrick & Company (now Patrick Partners), 3,232,700 shares; D. J. Carmichael & Co., 3,050,000 shares; Saw, Cambridge & Brannelly, 1,000,000 shares; and T. A. James & Co. (Perth brokers), 250,000 shares. In addition, a group referred to by D. J. Carmichael & Co. as the 'directors and promoters' received 2,700,000 shares for distribution (Ev. 2519 and Committee Document 11-1). A list of the quantities of shares allocated to 'Brokers, Companies and Others' for distribution was provided to the Committee and is to be seen in Committee Document 11-2. So although the prospectus said that the issue had been underwritten by two brokers, and the underwriting agreement gave these underwriters the right to nominate all the subscribers to the 10.2 million shares, in fact a Sydney broker not mentioned in the prospectus and a group known as the 'directors and promoters' were to play a larger role in the distribution of the shares than the underwriters themselves.

Mr Court explained that the involvement of Patrick & Company in the issue had arisen when ACM negotiated with Metals Exploration to take an interest in its Mount Keith nickel prospect - an event which, according to Mr Court, 'certainly stimulated a lot more interest in the company' (Ev. 2501). He added that 'there had not been a great deal [of interest] prior to that'. Mr Court also said that these negotiations 'brought Metals Exploration into the flotation, and their brokers Patrick & Company; and the size of the float was substantially increased at that stage, firstly to give an entitlement to shareholders in Metals Exploration, and secondly to give an allocation of shares for Patrick & Company to place in Sydney' (Ev. 2501). Mr Court explained that D. J. Carmichael & Co. had remained as the underwriters of the whole issue, but at about the same time an agreement had been entered into with Patrick & Company whereby this Sydney firm agreed to sub-underwrite and take firm the additional shares for the full underwriting commission: 'That is probably why we consider that they were underwriters, but technically they had been sub-underwriters in the issue' said Mr Court (Ev. 2501). Subsequent evidence showed that Patrick & Company sub-underwrote for the full underwriting commission of one cent a share the additional 3,232,700 shares which Mr Maloney said were for distribution in Sydney, and sub-underwrote for a commission of 0.75 cents a share all the 2,667,300 shares reserved for application by the shareholders of Metals Exploration. The balance of the underwriting fee of 0.25 cents a share on the shares reserved for shareholders of Metals Exploration was retained by D. J. Carmichael & Co. and Saw, Cambridge & Brannelly (Ev. 2520-22).

How the Shares were Distributed

Having established which firms and groups were to carry out the distribution of the 10.2 million shares and options reserved for the public, we sought information as to how these shares were finally allotted before the closing of the issue. We found that with the shares allocated to the 'directors and promoters', a substantial number was retained by the directors, their families, company officers, geologists and others associated either with ACM or with the four companies or individuals who had agreed to sell mineral claims and leases to ACM. One group which sold important nickel claims to ACM and its associate companies, and which received a large allocation of shares in the flotation, was known as The Albion Mineral Prospecting Syndicate. In response to our inquiries, a managing member of this syndicate, Mr W. J. Maund, told us how the syndicate had come to receive its allocation:

In reply to your letter of April 30th 1973 I wish to advise that I was not allocated 625,000 shares by Australian Consolidated Minerals N.L. for distribution amongst members of the public.

By an agreement dated January 23rd 1969, and registered on that day, numbered 577487, and stamped by The State Stamp Office Perth W.A. a group of people named in the agreement formed The Albion Mineral Prospecting Syndicate.

All the people to this agreement were known to each other, most related, and residents of the Wiluna-Mt Keith district.

A large area of prospective Mineral Bearing Claims were pegged and application to the W.A. Mines Department was successful. A large programme of investigation and prospecting work was performed. Over $30,000 was spent in the usual type of Mining operations together with deep drilling to locate ore bodies.

We had considerable success, the result being the discovery of Nickel Ore in considerable quantities at Kingston and Mt Keith.

The Mt Keith ore body is considered to be the largest ore body yet discovered in Australia, with estimated ore proved of over five hundred million tons.

About October 1969 The Albion Mineral Prospecting Syndicate were approached by Metals Exploration N.L. and Freeport of Australia Incorporated, and Australian Consolidated Minerals N.L. (a company yet to be incorporated) with an offer to purchase all the Mineral Claims.

The offer was accepted and an agreement of sale was duly signed on October 3rd 1969.

The shares you refer to were part of the sale price to Albion Mineral Prospecting Syndicate Members. They were not for distribution to the public.

The Syndicate supplied the list of all Members entitlement, according to their holdings, and a list of the allotments is enclosed ...

(Committee Document 11-3 emphasis by Committee)

Mr Maund also said that 'as an additional inducement to sell our claims to these people' the syndicate was allotted 'a further 250,000 shares which we paid 20 cents each for'. After receiving this information, the Committee carried out a further close examination of the ACM prospectus; however, we failed to find any information about a special issue of shares to the vendors as 'part of the sale price', nor did we find any reference to 250,000 shares being reserved in the flotation for the vendors. We concluded, therefore, that these shares referred to by Mr Maund were allocated from the shares which the prospectus said were being made available for public distribution. In response to a further inquiry, Mr Maund told us that the claims had been sold by the Albion Syndicate to ACM for $225,000 cash of which $175,000 had been used to subscribe for the number of shares the syndicate stipulated it wanted as one of the conditions of agreeing to sell the claims. According to Mr Maund, 'this was a verbal agreement but clearly understood by all parties' (Committee Document 11-4). In other words, of the 10.2 million shares said to be available to the public, a total of 875,000 shares was apparently pre-empted for one group of vendors and, according to Mr Maund, it was never intended that these shares would be made available generally to the public.

Our investigations also revealed that of the 3,232,700 shares available to Patrick & Company for public distribution, 2,032,700 shares, equal to about 63 per cent of the firm's total allocation, were taken up by six share-trading companies closely affiliated with the partners of the firm: Mining Traders Ltd (now Patrick Corporation), MTA Pty Ltd, MTB Pty Ltd, MTD Pty Ltd, Minwall Pty Ltd and Minsoul Pty Ltd. The partners' superannuation fund also acquired 50,000 shares (Ev. 2650 & 2652). Nine different nominee companies were involved in taking up all these shares. A further 100,000 shares from Patrick & Company's allocation were taken up by Pasar Investments Pty Ltd, a share-trading and investment company which was associated with both Patrick & Company and B. Hare & Associates Pty Limited, the company of mining and geological consultants which acted as the general manager of Metals Exploration. Mr B. Hare, a principal of B. Hare & Associates, was also the chairman and managing director of Metals Exploration, and he also acted as a consultant to Patrick & Company (Committee Document 11-5). The senior partner of Patrick & Company, Mr M.B.L. Dowling, was also a director of Metals Exploration. About 49 per cent of Pasar's capital was owned (through Patrick Nominees) by MTA Pty Ltd, one of the six share-trading companies just mentioned, and the principals of B. Hare & Associates in turn owned about 49 per cent of MTA's capital. The principals of B. Hare & Associates also held part of the share capital of Pasar. Apart from acquiring an interest in the ACM flotation through Pasar and MTA, the shareholders of B. Hare & Associates and their families acquired over 200,000 ACM shares in their own names. Mr Hare informed the Committee that he also secured an allocation of shares for his employees (Committee Document 11-5). The balance of the shares available to Patrick & Company for distribution was spread among clients of the firm.

The partners of D. J. Carmichael & Co. took up in the firm's nominee company 373,300 shares (an amount equal to about 12 per cent of the firm's total allocation) for themselves, their wives, and share-trading companies. Most of the remaining 2,676,700 shares were distributed to about 2,300 clients in small parcels of only a few hundred shares each (Ev. 2502). The partners of Saw, Cambridge & Brannelly took up 180,000 shares in their nominee company for three family sub-underwriting and share-trading companies, leaving most of the balance of 820,000 shares to be distributed among about 1,700 clients in quantities of between 200 to 1,000 shares. The partners of T. A. James & Co. said that they had received 250,000 shares to distribute because of their 'close association with a number of the promoting companies'. Of the 250,000 shares available to the firm, 26,500 shares were issued to members of the partners' families and to a proprietary share-trading company in which one partner and his wife held one-third of the shares (Committee Document 11-6). Most of the rest of the shares were distributed in small quantities of 200 to 1,000 shares.

Neither the stock exchange nor the State Government regulatory authorities have laid down any guidelines on the proportion of a public issue which may be retained by underwriters and brokers distributing the issue without first offering these to the genera] public, nor is there any requirement that the market be informed of the allotments made to such people. And in the ACM flotation there were apparently no questions asked about these aspects of the issue by any of the regulatory authorities. However, a search of the stock exchange files by the Committee revealed that an executive officer of the Sydney Exchange, Mr L. Foldes, did tell the Perth Exchange, which was the home exchange for ACM, that in his view any shares to be issued to 'promoters and vendors' in the flotation should be disclosed (Committee Document 11-7). But this executive failed in his attempt to bring about the disclosure, for the Perth Exchange agreed with the company that any shares which might be issued to the vendors were not part of the consideration for the sale of mineral claims but shares issued in response to a normal application from a member of the public. ACM wrote to the Perth Exchange twice about this matter, on 31 October and 3 November 1969, and on each occasion the company stated that there were no 'vendors' shares' as the vendors had sold their properties to ACM for cash and not for shares. In addition, according to ACM, the company was going to pay the cash to the vendors for their properties after the issue so that no money was being provided by ACM to the vendors to take up any shares (Committee Documents 11-8, 11-9). In a specific reference to The Albion Mineral Prospecting Syndicate, ACM said:

As to Albion Mineral Prospecting Syndicate, Australian Consolidated Minerals N.L. has not agreed to allot them shares in respect of the purchase of their mining tenements and as such it is not expected any allotment will be made to them unless they lodge an application for shares in the ordinary course of events through one of the Underwriting Brokers.

(Committee Document 11-9).

As we have already said, one of the managing members of the Albion Syndicate has provided us with a rather different account of the basis upon which the Syndicate participated in the ACM flotation. According to Mr Maund, one of the important conditions insisted upon by the Syndicate in its sale of the claims was that it be provided with an opportunity to subscribe for a large number of shares in the flotation. However, in this case-study we were not primarily concerned with the negotiations between the vendors and the promoters. Our main purpose was to find out how the 10.2 million shares were distributed to the public; and what is clear is that the general public did not receive a genuine opportunity to subscribe to a large proportion of this issue.

In summary, of the shares which the prospectus indicated were available for distribution to the public, approximately 26 per cent was retained directly and indirectly by four broking firms largely for share-trading purposes and for the beneficial interests of the stockbrokers; and if the shares taken up by the group known as the 'directors and promoters' were added to the total of those retained by the brokers, the proportion of the issue pre-empted by those responsible for the distribution would rise to well above 26 per cent. Because the prospectus did not disclose this plan of distribution, but, instead, said that all these shares would be available for public subscription, it was, in our view, significantly misleading. Before showing how some of the brokers who had had the responsibility for the distribution of most of these shares disposed of their holdings in the subsequent stock exchange market, we discuss some of the factors which heightened the demand for ACM securities in that market.

Influences on the Post-Flotation Market

Stock exchange trading in ACM shares and options began on 18 December 1969. The following day, under the heading 'ACM plays to packed house', the West Australian reported: 'The gallery of the stock exchange was airless and crowded to capacity yesterday as crowds jostled to watch the debut of Australian Consolidated Minerals N.L.'. Four months later, at the company's Statutory Meeting (17 April 1970), the chairman of ACM began his address to shareholders by reminding them of how the 'successful launching' of their company had been described by one observer as the 'Float of the Year' (Committee Document 11-10). The mining share market was in the grip of a speculative fever known as the 'Poseidon boom' in December 1969, and the securities of many companies were priced far beyond any rational value, which was one reason for the extraordinary interest in the ACM issue. In this flotation, however, there were some special factors affecting the demand for, and supply of, the shares and options, which helped to provide opportunities for the realisation of spectacular capital profits of up to 1100 per cent on the issue price.

One of the reasons for the large and widespread interest in the ACM securities up until, and just after, the flotation, was the series of public announcements which regularly reminded the market of the close link between Metals Exploration and ACM in the search for nickel deposits and of the encouraging developments of this nickel exploration. On 10 October 1969, for example (ten days after the famous announcement by Poseidon that the company had struck 40 feet of massive sulphides assaying 3.56 per cent nickel and 0.55 per cent copper), Metals Exploration issued a 'News Release' saying that arrangements had been made for the shareholders of Metals Exploration to

participate in a new company Australian Consolidated Minerals N.L. which is being formed to consolidate the interests of several Western Australian based companies currently participating with Metals Exploration N.L. in several Joint Ventures. Further details of the new company will be released by its Directors next week.

ACM was in fact incorporated on 10 October, the day of this announcement. On 23 October, the day the underwriting agreement for the ACM issue was signed, Metals Exploration issued a further 'News Release' advising that Freeport of Australia Inc., Australian Consolidated Minerals and Metals Exploration had purchased for cash '96 mineral claims totalling 28,171 acres north of and adjoining the Mt Keith area'. The announcement said that each company was to have 'an equal one third interest in these claims', which were referred to as the 'Kingston Nickel Prospect', and Metals Exploration was to be the manager of the venture. It was also reported that Metals Exploration had arranged for ACM to acquire part (50 per cent) of its interest in what was called the Mt Keith Joint Venture, and that percussion drilling at Mt Keith had 'disclosed widespread traces of nickel sulphides'. Diamond drilling was said to be in progress.

On 3 November, Metals Exploration was concerned to tell the market that it was not the 'promoter' of ACM, and that ACM was not a 'spin off' of Metals Exploration (Committee Document 11-11). There was no doubt, however, that the two companies were working closely together in nickel exploration, the overriding interest of the market, with Metals Exploration as the manager of the interesting ventures. One of the next reminders of the association between the two companies came from Metals Exploration on 27 November, when Mr R. Hare, in his chairman's address to Metals Exploration shareholders, referred to the Mt Keith Joint Venture with Freeport of Australia and ACM as the company's 'most interesting project' in Western Australia which, he said, 'is now emerging as a major nickel province of world importance'. In commenting on the Kingston and Mt Keith claims, Mr Hare said that 'shallow percussion drilling and a number of diamond drill holes has shown that nickel sulphides are widely disposed throughout the area'. He added that 'In places, concentration of sulphides has yielded assays of up to 1% nickel'.

As we have already mentioned, the Poseidon nickel boom was moving ahead at a fast rate at this stage, and the public had been made well aware of the fact that ACM was exploring in the renowned nickel belt with expert companies. The result was that one of the underwriters of the ACM flotation, D. J. Carmichael & Co., experienced a demand for the shares in response to the prospectus which was 'very widespread and very great'. The requests for shares from the firm's own clients exceeded the supply it had available for distribution, and in order that as many clients as possible could participate in the issue, most of the allocations were restricted to just a few hundred shares (Ev. 2502). Saw, Cambridge & Brannelly had a similar experience, and found it 'very difficult' deciding which clients would receive an allocation of shares. Mr Brannelly recalled spending 'two weekends going through every single ledger card in the office in trying to see the volume of business conducted and to allot accordingly' (Ev. 2514). The power to allocate shares meant the ability to make a gift to favoured clients, and it would seem that strong and continuing indications of interest in the float received during this period would have provided a kind of barometer of the build-up of buying demand which could only be expressed once trading had begun.

On 18 December, the day stock exchange trading began in the ACM securities, the ACM directors announced to 'All Exchanges and Press' that, since the issue of the prospectus, additional mineral claims had been acquired at Laverton, Yaloginda and in the Mt Clifford area. Laverton was near where Poseidon had made its remarkable nickel discovery, and Mt Clifford had recently been referred to as an area where Western Mining Corporation had discovered nickel. The claims in the latter area were to be worked by ACM itself, and the other claims were to form part of the joint ventures with Metals Exploration and Freeport of Australia. The directors also reported on 18 December that a managing director would be appointed 'to control the exploration activities of the company, and to ensure that its participation in the mineral growth within Australia and/or overseas is fully maintained'. In this way stock exchange trading in ACM shares and options began with the news that the company was already engaged in considerable and purposeful activity, and early in the new year (19 January 1970) another report indicated that the company had maintained its sense of urgency about pushing on with its exploration programme throughout the Christmas period. The claims at Laverton and Yaloginda were 'being currently investigated', the report said, and a further sixteen claims had been pegged on which a geological survey would 'shortly commence'.

Interest in the ACM share market was also stimulated by the circulation of rumours about the Mt Keith nickel deposit, an example of which was to be seen in a tipping-sheet issued in

January 1970 by Australian Investment Counsellors Pty Ltd (a Melbourne investment consultant whose activities and associations with stockbrokers have been described in Chapter 7). In an underlined passage in a review of ACM, the tipping-sheet reported: 'Persistent market talk is abroad that the partners have already outlined ore reserves of about one million averaging one per cent nickel'. The circular went on to say that 'there are many knowledgeable mining men who are of the opinion that Mt Keith will eventually prove to be a viable nickel mining operation'. In commenting on the ACM share price, this tipster's sheet said that the market had 'been rebuffed in an attempted advance above $1.50 no less than three times' but 'it is quite clear that any break above the $1.50 level is going to lead to a strong upward thrust' and 'it would not be surprising if the advance carried well over the $2.00 level'. There was not in fact a 'break' above $1.50 but, as we will show, at about this price particularly heavy selling began by one of the sub-underwriting broking firms (Patrick & Company) which had, through its nominees and associates, taken up a very large number of shares in the flotation. The date of this news-sheet was 21 January 1970. A week earlier the same news-sheet carried a tip that the ACM share price would rise; and a later edition on 4 February also included a recommendation to buy ACM shares. Favourable comments in the Press also directed attention to ACM; for example, on 5 January 1970, the Australian Miner included ACM as one of the five companies in its selection of 'Stocks for 1970', and referred especially to the directors who were described as being 'very well connected in the mining world'.

Apart from the factors we have already mentioned, there was in our view, another reason for the build-up in demand for ACM securities. At the time of the distribution of the public issue, many investors failed to receive any shares, and the strict rationing of the available supply among thousands of investors resulted in many of the allottees receiving smaller allotments than they desired. The fact that a substantial portion of the issue was taken up by a small number of people and companies had the effect of adding to the number of investors whose demands for shares in the issue were not satisfied. Thus during the public issue an emphasis came to be placed on the scarcity of the shares, and brokers stressed the difficulty of obtaining an allocation. The result was to heighten the interest in the shares, and to add to the buying interest which could only be implemented once stock exchange trading had begun.

On the day stock exchange trading opened, the directors not only made reference in their public announcement to the progress in pegging new nickel claims, but took the unusual course of stating that the company had 16,757 shareholders, including 2,078 residents in Britain. In accordance with stock exchange requirements, a schedule was also prepared and filed at the exchanges at about this time showing the twenty largest shareholders on the register of the company and the number of shares held by each of them (Committee Document 11-12). The twenty shareholders were listed as holding a total of 4,869,333 shares, which was equal to about 29 per cent of the issued capital. Included in the list were six bank nominee companies and three nominee companies of brokers, and both types of nominee companies would normally have been expected to have been holding shares for a number of shareholders and possibly many of them. It has been a common practice for many large shareholders to hold their shares through bank nominee companies. On the face of it, therefore, the issued shares of ACM were thinly spread among an unusually large number of investors in Australia and overseas, and it appeared that public subscriptions had filled the issue. Investors could have reasonably concluded that the supply of shares available for trading in the market immediately following the issue would primarily be determined by the investment decisions of thousands of members of the public with small shareholdings. In fact, however, the schedule of the twenty largest shareholders gave a misleading picture of the relative importance of the major holders of shares. For the nominee companies of brokers masked the large beneficial interests of the partners in these holdings, and in at least one instance the same shareholder used more than one nominee company to cloak one large holding. Our inquiries revealed that of the twenty large holders, seven of them, including five bank nominee companies, accounting for 1,452,700 shares, were nominees of one of the share-trading companies closely associated with Patrick & Company.

The Committee recognises that substantial quantities of shares in public issues are sometimes taken up by institutional investors as long-term holdings, and in the subsequent market trading these shares often cannot be counted on as part of the supply readily available to the market. Such tightening of the supply both in the public issue and in the stock exchange trading can lead to sharp movements in the post-flotation share price. In the ACM flotation, as we have described, among the relatively few and unknown purchasers of a substantial portion of the supply available for public allotment were brokers and their associates who had had the responsibility of the distribution of part of the issue to the public. In other words the contraction of the supply of shares in the flotation arose significantly from the actions of brokers, which in turn meant that the availability of shares to meet the demand in the subsequent market trading would be considerably affected by the decisions of brokers in respect of the supply under their control. How the brokers mainly involved in this flotation viewed their holdings, and how they deployed them in the post-flotation market will now be discussed.

Dealings by Saw Cambridge & Brannelly and D. J. Carmichael & Co.

The partners of Saw, Cambridge & Brannelly said that at the time of the ACM issue they had 'faith' in the company and had wanted to be long-term shareholders (Ev. 2516). In their opinion brokers should not sell straight after the listing of a new company, for 'to take a stag profit is not supporting a company in its issue ...' (Ev. 2517); they had therefore waited about a year before selling any of the 180,000 ACM shares taken up by their family companies. Mr Brannelly, who had been a member of the committee of the Perth Exchange, stressed that to him it was 'a matter of ethics' that an underwriter did not stag an issue, adding that in his view 'any broker with any ethics at all would not sell straight away' (Ev. 2518). Although Mr Brannelly held these strong views on the propriety of underwriters' trading in new issue shares, he and his partners did not insist at the time of the ACM flotation that the underwriters disclose their intention to take up a certain proportion of the issue, which would at least have alerted the company and the market to the possibility of the underwriters' selling in the post-issue market. In fact, according to Mr Cambridge, even though his firm had been an underwriter and was shown as such in the prospectus, it had not played any part in determining what information would be included in the prospectus (Ev. 2518).

We were told that within the firm of D. J. Carmichael & Co. the practice had been for the partners to take up shares in new issues for trading purposes, and Mr Court said that they regarded their participation in an issue in this way as 'part of our remuneration, as well as the underwriting figure' (Ev. 2503). Mr Court said he had traded in about half of his allocation, about a month after listing (Ev. 2505). Mr Maloney said that the shares taken up in the ACM flotation by his family company were bought 'certainly with the thought in mind of a trading profit' (Ev. 2504); and about a month after the shares were listed his family company had begun trading. In addition to the 280,000 shares taken up by the partners' family and their family companies, a further 93,000 shares were allocated to the firm's 'stock' account, which was a trading account owned by the partners. Mr Maloney said that this account had been 'in a very big mess' and that the ACM shares were retained from the public issue for the purpose of covering errors that might have been made in the distribution of shares in the flotation, and partly for trading purposes.

Patrick & Company's Dealings

Of greater size than the dealings of the underwriters to the ACM issue, were the dealings of Patrick & Company, a firm which underwrote about fifteen public flotations during the mineral boom, but which was classified as a sub-underwriter in the ACM flotation. Mr J. A. Keir, a partner of Patricks, told the Committee that the retention of about 62 per cent of Patrick & Company's allocation of ACM shares for six of the broking partnership's associated share-trading companies had been 'a bit higher than normal' (Ev. 2654), and he added that 'in the vicinity of 20-25 per cent would probably be normal, but there is no real rule of thumb'. He said that the allocations of 2,032,700 ACM shares among the six share-trading companies closely affiliated with Patrick & Company were as follows: Mining Traders Limited (now Patrick Corporation Ltd), 250,000 shares; MTA Pty Ltd, 50,000 shares; MTB Pty Ltd, 50,000 shares; MTD Pty Ltd, 1,557,700 shares; Minwall Pty Ltd, 50,000 shares; and Minsoul Pty Ltd, 75,000 shares. The latter five companies were subsidiaries of Mining Traders with various minority shareholders.

The price of ACM shares (which had cost 20 cents) at the close of trading on the opening day (18 December 1969) was about 78 cents, and the price of the options (which had been issued with the shares at no extra cost) about 50 cents. Prices then rose quickly, the shares reaching $1.15 on 24 December and $1.35 on 29 December, the next trading day. The share price remained at around that level, which was near the peak, for the next few weeks, and then steadily declined to about 32 cents in early June 1970. From then until the end of June the price recovered, to close at about 70 cents.

Six days after the first quotation of ACM's securities, one of the Patrick companies bought further shares. Mining Traders bought 100,000 shares on 24 December 1969 in Melbourne; 9,000 at $1.03, 41,000 at $1.05 and 50,000 at $1.10. That day about 279,000 shares were reported as sold in Melbourne, and 124,750 in Sydney; which meant that Mining Traders' dealings accounted for about 25 per cent of the gross turnover of these two exchanges and presumably had some effect in maintaining the price of the shares on that day. On 14 January 1970, another Patrick company, MTD Pty Ltd, bought 65,000 options at about their highest price for a total cost of $68,386. Mr Keir said he did not know the reason for the share purchases on 24 December (Ev. 2657), but subsequently Mr Dowling of the Patrick broking firm said that the reason was '... because the market was going well and there were big sellers in the market, and they were bought for a trading profit' (Ev. 2739). He also said that these purchases were not made in order to affect the market upwards, and the subsequent sales which quickly followed when the market was at its peak were 'unrelated transactions' (Ev. 2740).

These subsequent sales by the Patrick group began on 13 January, when the share prices ranged between $1.20 and $1.45. Beginning on 13 January 1970, and concluding on 15 January, the partners' superannuation fund sold all of its shares on the market. But the main selling on this occasion was for MTD Pty Ltd, one of the share-trading companies managed by Patrick & Company in which the partners of Patrick & Company directly and indirectly held more than 75 per cent of the capital. These ACM shares sold on account of MTD had been taken up during the flotation by nine nominee companies, including five bank nominee companies. In his evidence, Mr Keir was again unsure of the reasons for concealing this holding behind so many different nominee companies, among which were several nominee companies owned by the broking partnership (Ev. 2654); but in a subsequent letter to the Committee we were informed that it was 'for reasons of security' (Committee

Document 11-13). This use of nominees meant, of course, that neither the public nor the clients of Patrick & Company could tell how many shares were within the control of the one broking firm; and we have already noted how the cloaking of this one holding behind nine nominee companies meant that the schedule of the twenty largest shareholders provided to the stock exchanges at the time trading commenced misled the public as to the spread of ownership of the company.

The release into the market and to the clients of Patrick & Company of these ACM shares retained from the flotation in these nominee holdings took place in numerous transactions on many trading days. A total of 247,700 shares were sold for MTD in January, and a further 310,700 were sold in February. These shares had cost $111,680. The profit from their sale in that post-flotation market was about $522,000. In April, 305,100 shares were sold, in May 16,000, and in June the balance of about 680,000 were sold. Profits from all MTD's sales between January and June totalled about $770,000. In addition, at the end of June, MTD still held the ACM options which, with the exception of the 65,000 bought in January for $68,356, had cost nothing. These options had a market value of $618,526, at 30 June 1970.

For the month of April, MTD had done most of its selling by about the end of the third week. At that stage Mining Traders began to sell, disposing of about 99,000 shares before the close of the month. In May, MTD had completed most of its selling by about the end of the first week, but from then till the end of the month Mining Traders sold about 226,000 shares, and in the same period MTA Pty Ltd, MTB Pty Ltd and Minwall Pty Ltd disposed of their ACM shares. Mining Traders quit the balance of its shares in June (Ev. 2656-57). Details of share-trading by Minsoul Pty Ltd for this period are not known to the Committee.

For varying periods of time while the sales were taking place, Patrick & Company's selling on behalf of the Patrick companies was a substantial and sometimes major part of the gross turnover (which would include some double-counting) in ACM shares by the Stock Exchanges of Sydney, Melbourne, Brisbane, Adelaide and Perth. For instance, in the week to 16 January 1970, the selling by MTD and the partner's superannuation fund accounted for about 15 per cent of the gross turnover on all stock exchanges in ACM shares; during the week to 23 January, MTD's sales were 16 per cent of the combined turnover; to 6 February, 18 per cent; to 10 April, 26 per cent; to 17 April, 68 per cent; and to 5 June, 48 per cent. During a number of other weeks, the proportion of the market in ACM shares accounted for by the large-scale and continuing disposal of MTD's and its associates' shares ranged between 12 and 40 per cent, and for some periods the proportion would increase markedly if the transactions of the broking firm's 'Trading' account (to which we will refer shortly) were included. On the face of it, the disclosed turnover figures of the stock exchanges suggested that a free market was supplying the shares from numerous different holders to meet a heavy demand. In fact, as we have seen, the supply was coming significantly from a broker who had retained from the issue a very large number of shares for sale in the after market. In short, the post-flotation market came significantly under the influence of Patrick & Company's selling. That extremely large profits may be obtained from such market operations may be seen from the fact that the profit shown by the Patrick companies from their transactions in ACM securities in the period between the beginning of trading on 18 December 1969 and 30 June 1970 was about $1.5 million (valuing the remaining options at market value), about half of which was a realised profit. In addition to this profit, the Patrick broking firm received sub-underwriting commission and brokerage income from those clients who bought the shares unloaded by the Patrick companies after trading began.

11.24

Explanations

In a letter to the Committee of 13 October 1972, Mr Keir said that the ACM issue

> was not a prestige float at the time the sub-underwriting commitment was made, and, in fact, a shortfall in the issue was expected. It only became popular when the Poseidon discovery of nickel in areas near to those held by ACM caught the imagination of the market. This discovery was made almost coincidentally with the sub-underwriting commitment and did not have any influence on it.

(Committee Document 11-13)

The evidence available to the Committee shows, however, that ACM was not formally in existence on 29 September 1969, the time of the first announcement of the Poseidon discovery. The contracts for the purchase of important nickel claims in the Kingston and Mt Keith areas were dated 2 and 3 October 1969. ACM was incorporated on 10 October 1969, about ten days after the Poseidon announcement and the underwriting agreement was dated 23 October 1969. On the same day as D. J. Carmichael & Co. signed this underwriting agreement, it wrote to Patrick & Company offering the sub-underwriting and firm allotment of shares (Committee Document 11-14). The Melbourne office of Patrick & Company wrote to D. J. Carmichael & Co. accepting the sub-underwriting and firm allocation of ACM shares on 30 October (Committee Document 11-15; see also Ev. 2520 for modification of sub-underwriting fee), which was about four weeks after the announcement of the rich nickel discovery by Poseidon and after the 'Non-Ferrous Metals' share index of the Sydney Stock Exchange had climbed from about 3940 to 4207. On this evidence, the various events concerning the acquisition of key nickel claims, incorporation of the company, underwriting and sub-underwriting of the issue, and subsequent flotation, all took place after the Poseidon discovery, and in a market that was increasingly eager for nickel stocks.

However, even if there were reasons in late October 1969 for expecting a large shortfall of public subscriptions for the ACM shares, which led to some of the brokers carrying out the distribution to allocate to themselves and their associates large quantities of the shares while the issue was still open, we still believe the market should have been informed of these allocations. Mr Keir's view was that a prospectus should disclose when a broker is going to take (for his own companies or his associated companies) 25 per cent of the shares offered in a flotation for public subscription (Ev. 2655). In the case of the ACM issue, Patricks and their associates were responsible for distributing 3,232,700 shares out of a total of 10,232,700 shares to be offered to the public. 2,182,700 of these, equal to 21 per cent of the total, were taken up by the Patrick associates. Taking into account the shares retained by the other brokers carrying out the distribution, the proportion taken up by the brokers and their associates came to 26 per cent. When it was suggested by Senator Wriedt that the disclosure in the prospectus of Patrick's interest might have been desirable, Mr Keir said: 'I do not know whether I could agree with that. It was not our prerogative' (Ev. 2659-60).

Mr Keir also said that in the ACM flotation, Patrick & Company had been a sub-underwriter, 'bound by the Stock Exchange rules not to permit their name to be mentioned in the prospectus' (Committee Document 11-13, also Ev. 2656). The particular rule referred to here was as follows: 'The names of member firms shall not appear as sub-underwriters in a prospectus' (Sydney by-law 6A, now by-law 5, slightly reworded). This would not seem to have precluded the disclosure in a prospectus of the number of shares which a sub-underwriting broker was taking up directly or indirectly. In order to have more information on this matter we wrote to the General Manager (Mr D. M. Butcher) of the Sydney Stock Exchange to ask him whether there was any rule which precludes the disclosure in a prospectus of the number of shares which an underwriting or sub-underwriting broker is taking up. Mr Butcher said that the answer was '"no" as such', but he then drew attention to the rule which he said 'prohibits the appearance of sub-underwriters' names in prospectuses'. It seems to the Committee, therefore, that the by-law may not be entirely clear, and at any event, having regard to the many prospectuses we have examined, there is no rule which effectively requires brokers distributing shares in public issues to disclose the number of shares they and their associates are acquiring in the issue.

Mr Butcher also told the Committee that the rule forbidding the disclosure of sub-underwriters' names in a prospectus had been 'introduced largely to prevent an impression being given to the public of massive professional support for an issue, which could be misinterpreted by investors'. Judging from the evidence we have seen, however, markets have been distorted and investors have been misled as the result of brokers not disclosing their financial interest in substantial blocks of shares taken up in new issues and systematically sold in the subsequent market. It would appear that the stock exchange rules have been interpreted, and may have been framed, to allow brokers carrying out public issues to make substantial profits at the expense of a public unaware of the marketing arrangements for the issue.

Aspects of Self-Regulation

The foregoing evidence suggests that well before any trading began in ACM shares and options, events were taking place which had the effect of warping the balance between supply and demand in favour of those who were retaining shares from the public flotation for sale in the after market. None of the broker-dealers who acted as underwriters and sub-underwriters of the issue recognised any responsibility to the investing public to announce their interest in the flotation and to reveal how their actions were affecting the availability of shares both in the issue and in the subsequent stock exchange trading. A measure of the change in the pattern of ownership of ACM following the opening months of trading was provided by the chairman of the company in his address to shareholders at the Statutory Meeting on 17 April 1970. He said that whereas, at the time of the issue, 16,757 shareholders were on the company register, in April the figure had risen to 19,091 (Committee Document 11-10). The increase in the number of shareholders during these four months coincided with the release of many of the shares which had been withheld by brokers from the public issue for sale in the market once trading had begun. The impression given by the stock exchange documents was that an extremely wide distribution had been made to the general public of all the shares at the time of the flotation; but in practice the effective distribution to the public of a substantial number of shares took place only after stock exchange trading had begun, in circumstances which led to the public paying prices for the shares which were far in excess of the prospectus price.

That the stock exchanges have not introduced a rule requiring the disclosure of brokers' interests in public issues is, in our view, disturbing. We believe it is of the utmost materiality to the market to know when the supply of shares in a public flotation is being restricted through the retention of the shares by those carrying out its distribution, for only through such disclosure can investors judge whether a genuine offer has been made to the general public of all the shares said to be available for public subscription. Without this information investors cannot judge the extent to which the pattern of post-flotation trading may be influenced by the release of the shares retained from the issue for prompt sale in the after market. On several occasions in our inquiries information was given to us of broker participation in public issues to an extent that could significantly affect the supply of shares for trading and the price of those shares, and this aspect of new issues was one of the first matters we raised with the Perth Stock Exchange. The ACM flotation happens to be one case which we subsequently followed up in some detail, partly because it had other lessons which we discuss below. It seems likely that the kinds of problems disclosed by our inquiries into the ACM issue have been known to many stock exchange committeemen, yet up to the time of writing this Report the exchanges have not taken any action to alter their rules.

It was noted by the Committee that the two underwriting firms in the ACM issue, both members of the Perth Exchange, and both with partners who have been or are on the committee responsible for regulating the market, held opposing ideas on what are desirable practices in Australia by broker-underwriters engaged in organising a new issue. We also noticed a substantial difference between them in the extent of their understanding of the practices which have been taking place in the stock exchange market. As we have observed elsewhere in this Report, when brokers sit on their self-regulatory committees, they tend not to engage in an open discussion of market practices by their members; and they appear to have shown a reluctance to inquire in depth into the activities of member firms in order to obtain information on which new rules may be formulated, especially if the inquiry would mean looking closely into the affairs of fellow committee-men. Mr Brannelly told us, for example, that he could not recall any discussion either on the committee of the Perth Stock Exchange or among stock exchanges about whether there should be some rule governing the extent of stagging of shares by broker-underwriters in new issues (Ev. 2518). His firm had held strong views on the subject, but these views had not been discussed by the committee of which he was a member. If stock exchange committees are unwilling even to raise questions about such activities by their members, it is not surprising that the public has had little knowledge of the extent to which broker-underwriters have allotted shares to themselves in new issues for immediate trading purposes.

The reluctance of committees to intrude into members' affairs is also reflected in the regulatory procedures of the stock exchange executives, an example of which was to be seen in the ACM issue. When an executive of the Sydney Stock Exchange instituted some inquiries into the distribution of the shares in this flotation, his concern was not with the role of the brokers distributing the shares, but with the shares to be acquired by one group of vendors - a group of people who obtained a much smaller number of shares in the issue than the brokers. While the stock exchanges have frequently called upon public companies to accept the principle of full disclosure of information relevant to the establishment of an informed market and to rely upon the market to interpret the information sensibly, they have apparently found serious disadvantages in applying the same principle in respect to their own members' dealings.

Broker Attitudes to Underwriting and Public Issues

In the process of receiving evidence from the two underwriters of the ACM flotation, the Committee inquired into some general matters concerning the role of broker-underwriters in the market. The partners of Saw, Cambridge & Brannelly, Mr Leslie Graham Brannelly and Mr Geoffrey Owen Cambridge, were emphatic that with a popular flotation the broker-underwriter should have the sole say in deciding who should be the successful allottees of the shares. Their reason was that a broker's clients expect opportunities to participate in popular issues and it was in this way that the 'goodwill' of the broker's business was increased (Ev. 2510-11). They readily agreed that although the ACM flotation was publicised as a 'public issue', it had not been one in the sense that any member of the public could apply and stand a chance of obtaining an allotment (Ev. 2508). They regarded with some repugnance the idea suggested by the Committee that perhaps the public generally should have an opportunity of subscribing to a public issue, and not just the favoured clients of the broker-underwriter and the broker himself. 'You would have everybody else's clients taking shares, requesting shares and getting them. Then they would go back to their own broker' said Mr Cambridge, in a frank admission of a broker's interest in developing and running the underwriting side of his business (Ev. 2511). 'Applications would come from everywhere, the public, all round Australia' said Mr Brannelly, and he thought this would be 'cumbersome' and 'expensive' as there would be a '... multitude of applications probably far in excess of the shares available' (Ev. 2510).

The Committee was told that some ACM shares were made available by Saw, Cambridge & Brannelly to brokers of other exchanges for passing on to their clients, and it was expected that in this way Saw, Cambridge & Brannelly would enjoy the advantage of obtaining shares in new flotations in which the other brokers were concerned (Ev. 2514). We were told that, as an example of this practice, 40,000 ACM shares had been allocated to the firm's Adelaide agent, N. C. Shierlaw & Associates (Ev. 2515). However, our inquiries revealed that all of these shares were taken up for the benefit of either N. C. Shierlaw & Associates or the two share-trading and investment companies in which the principal of the broking firm, Mr N. C. Shierlaw, his family and his staff were the main shareholders. Trading profits were realised on some of the shares soon after they were quoted on the exchange. Again, therefore, the scope for public participation in the issue was restricted through the pre-emption of shares from the available supply for the purposes of share-trading by the broker carrying out the distribution.

Mr Maloney of D. J. Carmichael & Co. also agreed that the ACM flotation was 'not really public at all', and he said that members of the public could not get access to the shares in the way they can in the United Kingdom, for instance, where he thought 'a true public issue' had been developed (Ev. 2502). We were again informed how brokers seek to build up their brokerage business by underwriting new issues which they can then distribute to clients at favourable prices in order to attract new clients who wish to participate in such issues in future. In D. J.

Carmichael's case, this combination of underwriting and broking had been so successful that, according to Mr Maloney, the firm had 'ended up with a tremendous number of clients ... and we had to put on a huge staff ...' (Ev. 2506). Mr Court subsequently alluded to this expansion and some of its accompanying problems: 'Despite the very best systems that were introduced, when you take your staff from ten people to 130 or something like, it is inevitable that you have breakdowns in people, and certainly that did result in some problems' (Ev. 2506).

The main concern of the Committee about the role of broker-underwriting as expressed in this evidence is the cumulative effect of such attitudes and practices on the quality of new stock exchange flotations during periods when the new issue market is active. In the last new issue boom, for example, some brokers were so anxious to build up their brokerage businesses and profits by having a supply of relatively cheap new shares for their clients and themselves to trade in, that they gave little or no consideration to the soundness of the new ventures they sponsored and underwrote. Although the partners of both Saw, Cambridge & Brannelly and D. J. Carmichael & Co. said that they did carefully scrutinise the flotations with which they were concerned, we believe that attitudes similar to those which they expressed did result in such a scramble by some brokers for new issues to underwrite (in order to attract new brokerage clients who in turn demanded and made possible more and larger issues) that far too little attention was given to the question of whether the ventures being supported were well-founded ones. In some instances, so long as the brokers and promoters thought they could off-load the shares for a profit (and perhaps gain the taxation concessions available for subscribing to such companies), they were willing to sponsor and underwrite the new flotations. This is one way in which the over-heated boom was partially the brokers' own creation.

The evidence of the ACM underwriters also raises the question of whether an underwriter who is mainly interested in obtaining new shares at attractive prices for his clients and for himself to trade in, can, at the same time, adequately advise a company in need of new capital. For the main objective of such an underwriter must be to negotiate with the company for an issue price of the new shares which will be well below the market price of the shares when traded on the exchanges, and the more he succeeds in this aim the greater the satisfaction of his clients and the higher his own trading profit. In other words, the primary objective would seem to be to persuade a company making a new issue to sell its securities as cheaply as possible, which means raising the cost of capital to the company. Yet one of the main objectives of a company in seeking advice from an underwriter about the methods of raising funds is to keep down the cost of new capital. Thus there is a conflict between the apparent role of such underwriters as advisers to companies and their real and more immediate interest; and this raises doubts about the suitability of these firms as underwriters. The attitudes of brokers to new issues as expressed here would seem, inevitably, to make for inefficiency in the operation of the capital market. It is essential that it be recognised in the future that brokers and underwriters may not treat new issues as opportunities for profit-making and patronage in their own interest. Their rewards should be in the form of their commission in return for which they should discharge obligations to the issuing company and the securities market.

A further matter to be raised in this section concerns the question of the opportunity for investors generally to obtain shares in public issues. We have shown how a disproportionate number of the shares in the ACM flotation were distributed to directors, promoters, brokers and their associates and families, and we have expressed our views on this practice. Here we are concerned with the practice whereby the shares in highly regarded public issues are made available almost exclusively to the clients of one, and sometimes two or three, brokers. In our view this method of distribution has led to a sense of unfairness among some investors, and in the course of our inquiries we received numerous complaints from individuals about their difficulties of participating in popular issues. Sometimes a correct inference has been drawn by investors that a popular public issue has been largely confined to a select and privileged few in our society, which is a practice that could weaken the confidence among investors in the stock exchanges. We realise that there would be additional costs in providing the public generally with opportunities to subscribe to public issues; to begin with, many more prospectuses would have to be available. Also, many people would still fail to receive an allotment in some popular issues. Nevertheless, in our view, attention should be given to the development of issuing techniques which do not limit favoured issues predominantly to the favoured clients of one or a few brokers.

Conflicts of Broker-Dealers

Disclosure of Interest and Priority to Clients

Although the brokers distributing the ACM shares in the flotation were not required to disclose to the market the shares which they were themselves acquiring, we were concerned to know whether, in the normal course of events, when some of these shares were sold to clients, the brokers informed these clients of their interest in the transactions. General evidence on this aspect of the stock exchanges had already been received from a partner of the Patrick broking firm, Mr M.R.L. Dowling, who had for many years been a member of the committee of the Sydney Stock Exchange. When discussing the role of brokers who act as dealers in the share market, trading on their own account, he said that two problems can arise. One of these problems occurs when a broker trades against his client, and the other arises when a broker gives his own dealings preference to his client's orders. Concerning the first case, Mr Dowling said: 'This is covered both by the law and the rules of the exchange. Where a broker sells his own shares to a client or vice versa he must disclose that fact to his client, that is, he must say that he is acting in a principal position' (Ev. 2029). In respect of the second case, Mr Dowling said: 'Clients are highly aware and critical of the prices they obtain on the share market. To that extent the matter is largely self-policing. But the problem exists in theory at least and the clients' protection - alike with the client of any professional adviser - lies in the integrity of the broker' (Ev. 2029). Examples of the limitations of these rules and self-regulatory procedures in safeguarding the interests of investors may be seen in the case of the dealings of Patrick & Company and D. J. Carmichael & Co. in ACM shares in the months following the flotation of ACM.

Mr Keir (a partner of Patrick & Company) said that in negotiating the sale of the ACM shares held by the nominee companies for MTD Pty Ltd (in which, as we have said, Patrick & Company's partners held more than 75 per cent of the capital), Patrick & Company sold the securities to clients of the broking firm as well as to overseas brokers and to Australian brokers. However, the clients were not told of Patrick & Company's interest in the shares being sold to them (Ev. 2658); and Mr Keir was not aware of the clients of the broking firm having been told of MTD's holdings of ACM shares (Ev. 2658). We were also informed that when the partners of D. J. Carmichael & Co. sold the shares held by their share-trading companies to clients they did not disclose their interest in the shares being transferred (Committee Document 11-16). On the basis of this evidence, it would appear that investors cannot rely upon the stock exchanges to see that brokers disclose their interests in dealings they are carrying out with their clients.

Mr Keir also said that the sales made by Patrick & Company on behalf of MTD and the other associated companies 'certainly would not obtain a preference over other selling orders'. He said: 'Consideration would be taken as to when the order was placed, and what limit was placed on the order' (Ev. 2658). This procedure meant that although MTD was not given priority with its sales, these share sales were not withheld from the market until the sales of clients (within the same price limits) had been negotiated. As the ACM share price was falling between January and early June, partly, it would appear, as the result of the heavy selling by the Patrick companies, any delay in the implementation of clients' orders would seem to have resulted in their receiving lower prices for their shares. The Committee does not know whether any of the clients of Patrick & Company who sold their ACM shares reacted in the way described by Mr Dowling, and took steps to safeguard their own interests by complaining about the prices they received; but it is hard to see how they could when there was no public information available whereby members of the public could have judged whether their sales were being impeded by sales in which their broker was interested.

In this context we must again note the different practices of brokers involved in the ACM flotation, and the ways the different stock exchanges govern such practices. For in answer to Senator Durack's questions, the partners of Saw, Cambridge & Brannelly said that they believed it was a stock exchange regulation that all orders of partners and family companies could not be effected until all clients' orders were completed. 'You might be sitting there watching the market fall right away, but this is the principle which is adopted and must be adopted' said Mr Brannelly (Ev. 2518). The particular regulation in Perth covering this point is number 25, and it reads as follows:

A Member shall not buy or sell any securities for his own account or that of his firm or any partner therein or any employee thereof or for any account in which either he or a partner has a direct or indirect interest while such Member or his firm holds an unexecuted market order of a client to deal in the normal unit of trading in such securities.

For the purpose of this Regulation a limit order which cannot be executed owing to price differences shall not be deemed to be an unexecuted order.

According to this regulation, it would seem that Patrick & Company would have been obliged to withhold from the market any selling orders of the Patrick companies until such time as all the broking firm's clients' orders were completed, assuming these orders were not subject to price limits different from the current market prices. However, the Sydney Stock Exchange to which Patrick & Company belonged did not have, and still does not have, a regulation corresponding to the Perth one we have quoted. (The Melbourne Exchange, on the other hand, does have an article -number 104 - similar to Perth's regulation, though it does not give clients' orders priority over employees' orders.) We found no specific reference in the Sydney Stock Exchange rules to the way in which a member must treat his own orders, or orders for accounts in which he has an interest when, at the same time, he has clients' orders for execution. The decision as to whether clients' orders have priority over orders for accounts in which the broker himself is interested is apparently left to the discretion of the individual broker and, in the case we have been discussing, Patrick & Company's clients did not obtain this priority.

In the quotation above of the Perth regulation (25) there is reference to unexecuted clients' orders with specific price limitations, and a member of that exchange is not restricted from selling for accounts in which he has an interest at a price below a client's limit price. Melbourne article 104 is to the same effect. Hence, even if this rule had applied in the case of Patrick's sales of ACM shares, Patricks could have continued to sell on the downswing in the market, the downswing arising partly from their own selling, leaving suspended the orders of clients wishing to sell.

Our inquiries revealed that there is a by-law (number 69) of the Sydney Exchange which requires clients' orders to be completed 'before orders on the same terms on account of employees' of a broking firm, and in a letter to us dated 12 July 1973 the General Manager of the Sydney Exchange, Mr D. M. Butcher, said that this by-law 'covers ... any employee of a Member Firm, whether that employee be a member or a non-member'. However, the by-law does not say that the term 'employee' includes 'members', that is, the principals of the firm, as well as 'non-members'; and in our view, bearing in mind that broking firms are not incorporated, there would be no basis for the partners of a broking firm to regard themselves as its 'employees'. Mr Butcher also said that

... the Committee would certainly take the attitude that a principal would, in the spirit of the rules, come within at least the same ethical principles as employees, and any contravention would come under review by the Committee, in terms of its general powers under the Articles.

But as we have shown many times in this Report, some members of the stock exchanges are seldom concerned with 'the spirit of the rules'. In the ACM dealings, for instance, the partners of Patrick & Company did not regard themselves as being obliged by the 'spirit of the rules' to disclose to their firm's clients the major interest they had in the ACM sales they were effecting, nor did they regard the 'spirit of the rules' as requiring them to give clients' orders priority over orders for the accounts in which they were interested. It should also be said that although the General Manager of the Sydney Stock Exchange may think the committee members should, and may believe they do, have regard to 'the spirit' of the rules, he is not himself a member of the committee; in addition he has no power to investigate the records of member firms or committeemen (to whom he is responsible as an employee) to find out whether the rules are being followed. It seems so surprising that the Sydney Exchange has not introduced a rule specifically requiring members to give priority to their clients' orders, that the question arises whether some members deliberately did not state the need for such a rule, or whether, because of conflicting interests, they failed to face up to the matter.

Attitudes to Associated Share-Trading Companies

An examination of Patrick & Company's records showed that at the same time as the firm was selling ACM shares for MTD Pty Ltd, it was actively involved in the market in buying and selling a large number of shares both for clients and for its 'Trading Account'. Many of the transactions of this latter account were with London and European brokers and financial firms, as well as with Australian brokers and clients. When discussing the dealings of this 'Trading Account' in ACM shares, Mr Keir said:

They [ACM shares] would appear to have been going in and out of trading account on the one day, as I explained previously, which was a habit of our operators at that point of time. When they had a large quantity of selling orders, they would use [Trading Account] 41.

(Ev. 2658)

In evidence before the Committee, it appeared at first that some of the sales passing through Patrick & Company's 'Trading Account' were sales on behalf of MTD; in other words the 'Trading Account' was acting as the seller in the transactions and later accounting to MTD for the proceeds (Ev. 2657-58). This was an activity the 'Trading Account' of Patrick & Company sometimes entered into for the Patrick share-trading companies (see Chapter 10). However, Mr

Keir subsequently informed us in correspondence that MTD's sales had not passed through the 'Trading Account' in this way, but had been credited as sales to an account called 'Yarra Investments'. This name was the abbreviated form of Yarra Investments Pty Ltd, which was a company the partners of Patrick & Company had been expecting to purchase in late 1969. It was apparently intended that Yarra Investments would be the beneficial owner of many of the ACM shares taken up by nominees in the float. But when a delay occurred in the purchase of this company, it was decided to incorporate MTD Pty Ltd (which took place on 3 February 1970) and to transfer the sales of ACM shares on account of Yarra Investments to MTD's account (Committee Document 11-13). Yarra Investments Pty Ltd was subsequently purchased in 1970 by the partners of Patrick & Company and it became one of the many investment and share-trading companies associated with the firm (Ev. 2650).

On several occasions in this Report we have referred to the various interrelationships between the Patrick broking firm and the share-trading companies that surrounded the firm. We have already noted how Mr Dowling regarded the broking firm and its main associate, Patrick Corporation Limited (known as Mining Traders Ltd until 1970), together with the various interests of Patrick Corporation, 'as an entity' (Ev. 1460). From our own inquiries, we have concluded that the many and large share dealings of the Patrick companies were intimately and inseparably interwoven with the operations of the Patrick stockbroking firm. Mr Dowling said, however, that when Patricks, as a member firm of the stock exchange, carried out orders for the partnership's associated companies, the companies were treated as clients, 'no different from any other [client]' (Ev. 1958, 1962 & 2029). Mr Keir also said in evidence that MTD Pty Ltd was treated as a 'client' in its transactions in ACM shares and options (Ev. 2658).

Apart from the general difficulty of seeing how a share-trading group which was so intimately bound up with the broking firm could, at the same time, properly be regarded as a 'client' of the broking firm, a special difficulty arises in MTD's case. Our inquiries showed that MTD's share-trading, totalling about $8 million for profits of about $1.9 million during the period December 1969 to June 1971, passed through Patrick & Company without incurring brokerage. MTD was therefore given a valuable privilege which, according to the chairman of the Sydney Stock Exchange (Mr J. H. Cooper), was only available to members of the exchange (see Ev. 2649). The explanation given by Mr Dowling as to why MTD did not pay brokerage was that the 'partners owned, directly or indirectly, in excess of 75% of its issued capital' (Committee Document 11-17). In other words, MTD was so closely identified with the firm of Patrick & Company that its dealings were treated as if they were the partners' own dealings and able to enjoy a privilege only available to members of the stock exchange. Thus the partners of Patricks had it both ways. On the one hand, they regarded MTD as a 'client' and felt under no obligation to disclose its dealings as if they were their own; indeed, by dubbing their associated company a 'client' they would seem to have imposed an obligation upon themselves <u>not</u> to disclose its transactions to investors dealing with the broking firm. On the other hand, at the same time, and in the same transactions, the partners regarded MTD not as a client but as an integral part of their own business with the advantage of being exempt from brokerage charges.

In our view the evidence of this chapter (as well as extensive evidence elsewhere in this Report) shows that the share-trading companies closely associated with brokers cannot be regarded as operating at arm's length from the brokers concerned. D. J. Carmichael's partners looked to their share-trading companies for part of their profit from underwriting, as well as their underwriting commission. In the case of Patricks, the partners had such a large shareholding in MTD, and they benefited so greatly from MTD's highly profitable trading which they managed, that the realistic interpretation of the relationship is that the partners had a most special interest in MTD, quite different from a broker's normal interest in a client's dealings. We are left in no doubt that investors seeking advice from Patrick & Company and D. J. Carmichael & Co. on ACM shares and options should have been permitted to evaluate the overlapping motivations of these firms, through the appropriate disclosure, in order to decide the extent to which these firms were serving their own financial self-interest or their clients' interests.

Having said that, however, we must also say that the responsibility for ensuring such disclosure has rested with the stock exchanges. Once again, some committeemen of the stock exchanges have known of the practices of sharebrokers trading extensively in the markets in competition with their clients through associated companies and without their clients knowing, yet they have permitted the practice to continue unchecked to this day. The Sydney committee has even permitted a rule to exist which may be regarded as giving some basis for the claim by brokers that their own share-trading companies are 'clients'. For instance, in reply to an inquiry from us, the chairman of the Sydney Stock Exchange (Mr J. H. Cooper) said, on 14 December 1971:

... the brokerage by-law covers the charging of brokerage for both buying and selling to all persons or all organisations, other than members or partners of member firms, and is therefore applicable to wives, relations, family companies and associated companies.

I have no knowledge of any exception being made to the requirements of the by-law during the past five years.

(Committee Document 11-18)

Judging from his letter, Mr Cooper, as recently as December 1971, would seem to have been unaware of the fact that some of his members were not charging brokerage to their associated and family companies. However, the main point we wish to make here is that in respect of the charging of brokerage a broker's associated or family company is placed in the same category as all other members of the public. Under the by-law, the associated company is not regarded as part of or an extension of the member's brokerage business; it is, in effect, put in the same classification as general clients. It seems that the continued existence of this by-law in its present form again reflects the unwillingness of the stock exchange committees to adjust their self-regulatory procedures to the realities of the market. So long as the by-law remains as it is, it can be regarded as serving the self-interest of some members, including committee members, rather than the public. The requirements that associated and family companies pay brokerage can be ignored with impunity, and the chairman of the exchange may be kept unaware of its happening; yet, at %he same time, the by-law can be regarded by individual brokers as the stock exchange authority for not fulfilling their fiduciary duty of disclosing their interest in the transactions they are conducting with their clients.

Further Conflicts

Apart from being an example of the problem facing brokers who deal for their own interests while conducting agency transactions for their clients, the ACM dealings give rise to other questions about the conflict of interests facing broker-directors. There are many brokers who act as directors of public companies in Australia, and in a number of instances we have observed these brokers recommending the shares of companies of Which they are directors. Two recent examples were Ian Potter & Co.'s recommendation in July 1972 of the shares of Ansett Transport Industries Ltd of which Sir Cecil Looker, the senior partner of the broking firm, is a director; and Mr N. C. Shierlaw's recommendation in May 1973 of Poseidon Limited of which he is a director. In the case of ACM, none of the directors were brokers.

However, the senior partner of Patrick & Company was a director of Metals Exploration, which was the manager of the Mt Keith and Kingston Joint Ventures with ACM in nickel exploration. In February and March 1970, Patrick & Company circulated to clients two investment newsletters which commented favourably upon several companies, including Metals Exploration. In February, the firm's comments on Metals Exploration included the following:

With the announcement of a likely go-ahead for the Greenvale, Queensland lateritic nickel deposit, delivery of nickel to W.M.C. from Nepean, W.A. and with the Mt Keith-Kingston W.A. nickel prospect at a very interesting stage of exploration, Metals Exploration is now confirmed as a major stock ... Metals Exploration as well as its own one-third interest in both the Kingston and Mt Keith prospects, was one of the sponsors of AUSTRALIAN CONSOLIDATED MINERALS N.L. which will have a one-third interest in the Kingston leases and 16 2/3 per cent interest in the Mt Keith leases.
In Metals Exploration's report for the September quarter, directors said drilling at Kingston-Mt Keith had disclosed widespread traces of nickel sulphides, with zones of higher concentration in which values ranged up to 1 per cent nickel. No. 1 Hole intersected 5 feet of 1.21 per cent nickel which included a 6 inch vein of solid sulphides assaying 3.74 per cent nickel at a vertical depth of approximately 400 feet below the surface.

In March, the newsletter was entirely concerned with Metals Exploration, and the shares were 'strongly recommended as the most outstanding method of participating in the highly profitable Australian nickel mining industry'. A section of the review devoted to 'EXPLORATION - NICKEL' read:

MT KEITH, WESTERN AUSTRALIA: Metals Exploration's most interesting project is at Mt Keith north of Kalgoorlie in Western Australia. Here, Metals Exploration has a 1/3 interest (with Freeport retaining a half interest and Australian Consolidated Minerals a 16 2/3% interest) in this very promising prospect in the East Murchison Goldfield which has produced significant assays of up to 1.2% nickel. There are three diamond drills working at present. Results indicate nickel mineralisation of up to 64 feet widths. The area is extensive and the companies are intensifying their search. Preliminary metallurgical tests indicate a high grade nickel sulphide concentrate could be produced with a satisfactory recovery but the economics are as yet unassessable. Included in this project are 105 mineral claims at Kingston which the three partners share on a 1/3% (sic) each basis.

Although there was no specific recommendation that clients buy shares in ACM, it seems to us that Patrick & Company's clients could reasonably have inferred that the firm regarded that company's nickel prospects pretty favourably, and they might have believed that Patrick & Company could speak with special authority on the subject in view of the firm's association with Metals Exploration through its senior partner. Even if the partners had not themselves had an interest in dealing in the market in ACM shares at that time, the writing of such newsletters would have required great care in order to ensure that the recommendations, expressed and implied, were arrived at only after an objective consideration of the published information. But in fact during the period when these newsletters were published, Patrick & Company was engaged in large-scale and extremely profitable selling of ACM shares for accounts in which the partners had a most substantial interest.

The broking firm had thereby placed itself in a highly delicate situation. As the result of its large allocation of shares to its associates, the supply of ACM shares and options in the public issue and in the post-flotation market had been substantially tightened; and through the use of many nominee names the beneficial owners of these allocations had been hidden from the public. Shortly after quotation had begun, further buying by the firm for its associates had absorbed additional quantities of shares from the market, The newsletters which followed in

February and March would seem to have had the effect of stimulating the demand for the securities at about the time the supply to the market was increasing as the result of the massive sale of the shares by the Patrick interests. It is not easy to see how the varying and conflicting interests of the broker could have been resolved to the satisfaction of the broker's clients; but in our view the broker should, as a minimum requirement, have been bound to make a full disclosure to clients of the conflicting interests and positions of the partners. Yet the stock exchange rules did not require the disclosure and, as we have seen, no such disclosure was made. This is another reason why we believe a change is needed in the present regulatory system in order to reassert the importance of the public interest in the framing of stock exchange rules and in the policing of those rules.

Concluding Comments: Contrasting Performances in Self-Regulation

There does not appear to have been any previous extensive governmental inquiry in Australia into undesirable practices which may be associated with the allocation by underwriters and brokers-to-an-issue of shares in new issues. But documentation of such practices as carried on in overseas markets has been available for decades. The hearings of the United States Senate Committee on Banking and Currency on stock market practices of the 1920s and early 1930s produced detailed evidence of them in 1934. More recently, the 'hot issues' boom of 1959 to 1961 in the United States led to several analyses of the methods by which underwriters and others may stimulate demand for, and restrict the supply of, shares in new issues so as to inflate prices in the after-issue market to artificial levels. All this experience has led to the adoption of rules and procedures, by both government and self-regulatory bodies in the United States, which are designed to control the practices and protect the investing public.

The U.S. legislation and the Securities and Exchange Commission (in exercise of powers principally directed at fostering disclosure) have concentrated on requiring disclosure of the actual plan of distribution of an issue with details of allocations to underwriters, brokers and their associates and relatives and at prohibiting or treating as fraudulent many of the trading activities, statements and other practices which may be used by underwriters and brokers to an issue to stimulate demand, tighten supply or reap profit in the after-issue market. The attention of the Committee has been drawn, inter alia, to an article in The Business Lawyer for January 1962 on 'The Hot Issue' in which the author (E. H. Rotberg) comments on the legality of sales to fictitious accounts under these laws:

... a purported sale to fictitious accounts controlled by syndicate members for the purpose of masking the retention of shares violates the Securities Act for failure to make proper disclosure to the public investor, the Exchange Act as a manipulative practice, and the rules relating to ethical and fair practices of the National Association of Security Dealers.

Recently, in releases of July 1972, following its 'hot issues' hearings from February 1972, the SEC has expanded and developed its disclosure requirements.

Your Committee has also noted with particular interest the role and views in this context of the self-regulatory body of brokers, dealers and underwriters registered under the U.S. securities regulation, known as the National Association of Securities Dealers (NASD). The NASD has gone beyond disclosure of allocations to accounts of underwriters, brokers-to-an-issue, their relatives, associates and some others, to lay down standards for what constitutes a bona fide public offering, involving controls on when securities can be so allocated. As long ago as 1959 the NASD issued an interpretation, since revised in some respects, of its rule of 'Fair Practice' which requires a member to observe 'high standards of commercial honour and just and equitable principles of trade'. In this interpretation it said that members

... have an obligation to make a bona fide public offering price, of securities acquired by a participation in any distribution, whether acquired as an underwriter, a selling group member, or from a member participating in the distribution as an underwriter or selling group member. The failure to make a bona fide public offering when there is a great demand for an issue can be a factor in artificially raising the price. Not only is such failure in contravention of ethical practices but it impairs public confidence in the fairness of the securities business.

It also said -

A member is in a position of trust, when it has information with respect to a particular security, the indicated demand, and other factors, bearing on its future price not generally known to the public. To take unfair advantage of such a position as a participant in an offering indicates a lack of commercial honor.

The 'Interpretation' went on to provide, subject to exceptions, that 'if a member either has unfilled orders from the public or has failed to make a bona fide public offering of the securities acquired' as described above, it would be a violation of the Rules of Fair Practice for a member directly or indirectly to 'sell' any of its participation by

(1) continuing to hold any of the securities in the member's accounts;

(2) selling any of the securities to any officer, director, partner, employee, or agent of the member or of any other member or to a member of the immediate family of any such person;

(3) selling any of the securities to any senior officer of a bank, of an insurance company, or of any other 'institutional type' account; or to any person in the securities department of, or whose activities involve or are related to the function of buying or selling securities for a bank, insurance company or other institutional type account; or to a member of the immediate family of such persons;

(4) selling any of the securities to any account in which any person specified in (1), (2) or (3) has a beneficial interest;

(5) selling any of the securities at or above the public offering price, to any other broker or dealer.

The interpretation added that sales of any of the securities acquired as described 'to the accounts of banks, trust companies or other conduits for undisclosed principals shall not relieve a member of its responsibility to insure that the ultimate purchaser' is not an account within the purview of the provisions, of categories (2), (3) or (4) above.

The interpretation went on to say, however, that a member might withhold for his own account or sell to persons in categories (2), (3) or (4) part of its participation in an offering if prepared to demonstrate that the securities were withheld 'for bona fide investment in accordance with the member's normal investment practice, or were sold to such other persons for bona fide investment in accordance with their normal investment practice with the member and that the aggregate of the securities so withheld and sold is insubstantial and not disproportionate in amount as compared to sales to members of the public'.

It was also said that securities might be sold to another member in the fifth category above if the latter 'represents to the selling member and is prepared to demonstrate that such purchase was made to fill orders, as an accommodation and without compensation, for bona fide public customers at the public offering price'. Further, if such accommodation order were filled for any person in categories (2), (3) or (4) above, the member filling the order for such person was obliged to 'represent to the selling member and be prepared to demonstrate that such sale was for bona fide investment in accordance with the normal investment practice of such person with the member'.

'Normal investment practice' was defined by the interpretation to mean the history of investment in an account with the member. It was added that if such history disclosed 'a practice of purchasing mainly "hot issues", such record would not constitute a "normal investment practice"' as used in the interpretation. If the account involved was that of the member, such account had to be 'clearly an investment account as distinct from a regular inventory or trading account'.

Very recently, as a result of its 'hot issue' hearings in 1972, the SEC, while recognising the value of the NASD rules, considered that more should be done by this self-regulatory body to ensure an 'adequate float'. It accordingly has recommended that the NASD consider use of its powers to establish further guidelines of what constitutes a 'bona fide public offering'.

The Committee is impressed by the self-regulatory effort made in the United States to encourage genuine public distributions. That effort is partly due, no doubt, to the independence of the NASD executive, and to the pressure of the SEC. Clearly, if there had been such rules with respect to the practices of underwriters, promoters and brokers to the 'hot issues' of the mineral share boom in Australia, and they had been observed, much of the profiteering abuse by brokers and underwriters of the investing public which we have experienced would not have occurred. These self-regulatory rules were in existence for many years before the Poseidon boom. Some Australian brokers had sufficient awareness of the overseas experience and of the regulatory pattern to have recognised the classic signs of a 'hot issue' period and to have known what was necessary to protect the market from abuses. If they had any genuine feeling of obligation to ensure an adequately self-regulated market, they should at least have initiated action to have such rules adopted. Admittedly enforcement is another matter. But the Australian regulatory system has not even spelled out the requirements of a fair public market in relation to the allocation and marketing of shares in new issues.

Interrelationships between Private and Public Issues

In the preceding case-study we have discussed why the regulatory authorities should be more concerned with the distribution and marketing arrangements of public issues of new shares. Here we give an example to suggest why, when regulating such matters relating to an issue of new shares, the authorities should also be concerned with the way any previously issued shares have been distributed.

Flinders Petroleum No Liability was incorporated in Victoria in June 1968, and was floated as a public company in March 1969 with the stockbroking firm of Patrick & Company as the underwriter of 3 million 50-cent shares paid to 5 cents and 450,000 50-cent shares paid to 20 cents. Preceding this public issue of 3,450,000 shares, however, a total of 20,000,500 shares (19,000,500 of 50 cents each paid to 5 cents, and 1,000,000 of 50 cents each paid to 20 cents) had been allotted by a 'private' issue. Although over 80 subscribers had taken up these shares issued privately, the largest allotments were to companies closely associated with Patrick & Company and R. Hare & Associates, the latter firm being described as 'General Managers' of Flinders Petroleum in the prospectus of the public issue. When Mr M.R.L. Dowling of the Patrick stockbroking firm was giving evidence, he said:

Flinders was a private issue in June 1968. The bulk of the subscription came - you have recited them all - from the firm partnership, from Mining Traders and from Hare and Associates basically. Subsequently, the company issued a prospectus and made quite a minor issue to the public, nine months after the original shares were subscribed for in cash. Now Flinders had no vendor shares, they were all subscribed in cash, which of course is pretty uncommon. It is the only one of its kind; all the rest were pretty loaded. The reason was that we wanted to start off an oil exploration company because, as you would know, there were taxation deductions available in so doing which were removed by the Government subsequently. We thought the proper way to do things was to put up your own money, go and get tenements, go and get projects so you had something fit for a prospectus, and then make a minor issue to the public ...

(Ev. 2736)

The numbers of shares taken up in the private issue by the Patrick companies were:

Mining Traders Ltd	2,600,000
Patrick Securities Ltd	1,000,000
MTA Pty Ltd	250,000
MTB Pty Ltd	250,000
Minsoul Pty Ltd	325,000

In addition, Pasar Investments Pty Ltd, the investment and share-trading company associated with both Patricks and R. Hare & Associates, took up 2,040,000 shares, and Mr Hare's wife, Mrs B.M. Hare, took up 400,000 shares. Two other subscribers were Toxteth Exploration Company Pty Ltd, 1,000,000 shares, and Patrick Nominees, 1,953,000 shares. These last two holdings were held for the beneficial interest of the stockbroking firm, Patrick & Company. So of the 20,000,500 shares issued privately before tile flotation, about 49 per cent were effectively under the control of the Patrick group and R. Hare & Associates; and as the subsequent public issue was so small in relation to the existing issued capital, this proportion was reduced to only about 42 per cent by the flotation. The directors representing these shareholdings were Messrs J. E. Roberts, G. J. Stephens, A. W. Muddyman and R.H. Stowe. Mr Roberts, the chairman, was also a director of Mining Traders Ltd, and Mr Stephens, the managing director, was described in the prospectus as having been made 'available' by R. Hare & Associates. Mr Muddyman was to become the director of several companies floated by Patrick & Company during the mineral share boom.

In this instance, the Committee's concern was not with the method of distribution of the new shares in the public issue, but with the fact that the prospectus for this issue gave no information on the existing and very substantial share interests of Patrick & Company and R. Hare & Associates acquired by means of a preceding private issue. When Mr Dowling was asked to comment on this matter, he said:

... Personally I would think that if you have a company that has its shares all issued and issued for cash, to come out and put in the prospectus that so-and-so holds this much and so-and-so holds that much would be very much plugging your name to try to persuade people to buy shares. I think it would really be rather improper to make too much advertisement of it ....

(Ev. 2736)

Mr Hare's comment in a letter to the Committee was:

I do not believe it would have served any good purpose to have listed the major shareholders in Flinders Petroleum N.L. before the public float. The people associated with the company had subscribed a substantial amount in cash to acquire petroleum tenements before the float, and in any event the identity of the original shareholders was available for anyone wishing to check on this point.

In respect of Mr Hare's last comment, an examination of public records would not have adequately revealed the extent to which the Flinders company was closely involved with Patricks and R. Hare & Associates. A search of the public documents would have revealed that Toxteth and Patrick Nominees held 3 million shares, but would not have shown that Patrick & Company was the beneficial owner of these shares. Nor would it have shown the relationship between R. Hare & Associates and MTA, and that between MTA and Pasar (already referred to in this chapter). Mr Hare's interest in MTA was held by Mining Traders in trust for him, and MTA's interest in Pasar was held by Patrick Nominees. Mr Dowling said that people interested 'could ask ... and they would be told. There was no secret about it' (Ev. 2737). But the use of nominees to hold various interests suggests that it was not intended that the public know of some of the associations. This Committee, for instance, experienced some difficulty and delay in ascertaining the relationships between the Patrick companies, R. Hare & Associates and Pasar. Moreover, we doubt whether the Melbourne Stock Exchange executives (who did make some inquiries about the ownership of the privately issued shares) were aware of the interrelationships of the various Patrick companies with Patrick & Company.

While we do not wish to imply that there was any abuse of the post-flotation market by the holders of the privately-placed shares in the case of Flinders Petroleum, several general questions are raised by this example. First, the order of events in which a large private placement is succeeded by a public issue of a smaller number of shares of the same class, with both issues receiving stock exchange quotation, obviously creates potential for abuse and/or evasion of controls such as those intended to deal with 'hot issues' of the type discussed in the preceding section. It will be readily perceived that an underwriting firm and its associates which have acquired shares through a private placement preceding the public issue may use these shares, rather than shares taken up in the public issue, to bring the post-flotation market within their influence. Secondly, the question arises whether holders of the privately-placed shares should be allowed to sell these shares on the exchanges, at least without disclosure that the shares were part of the earlier private placement. Another question of some difficulty is whether the stock exchanges should be permitted to quote privately-placed shares at the same time as those publicly issued, especially where the privately-held portion greatly outnumbers that which is publicly held. In such circumstances it is doubtful whether there can be free play of supply and demand in a genuine public market, and the opportunities for manipulation and the establishment of false prices are thereby increased.

Turning specifically to the Flinders float, in our view it was important for the investing public, endeavouring to evaluate the character of the company, to have known that the broker-underwriters and, in effect, the promoters, controlled, directly and indirectly through their associated investment and share-trading companies, large numbers of the shares already on issue. It may be, as Mr Dowling said (Ev. 2737), many subscribers to the public issue knew of Patrick & Company's association with the venture other than as underwriters, but this should have been clearly stated in the public document. Amendments to the Companies Acts of recent years require companies to maintain a register of substantial beneficial shareholdings held directly or indirectly, so that such details would now be available for inspection. It is still important, however, for a prospectus inviting public subscriptions to include such details.

The Committee finally notes in passing that when Flinders Petroleum made a takeover bid for another company, Farmout Drillers N.L., in July 1969, the documents accompanying the bid did not reveal the major shareholding interest of the principals of Patrick & Company and R. Hare & Associates in both the offeror and offeree companies. In the case of the offeree company, investment and share-trading companies associated with Patricks and R. Hare & Associates held large shareholdings, and R. Hare & Associates were the 'General Managers'. Mr R. Hare was also a director of Farmout, and he did disclose the shares he held personally in both companies at the time of the bid. However, the stock exchanges were not informed that effective control of both companies was already held by groups associated with the broking firm and the firm of consulting geologists which acted for both companies (Ev. 2735-38). In our view, if it is relevant to require the disclosure of the personal holdings of the directors in such circumstances, it is relevant to require the disclosure of their indirect interests as well. In the absence of the full information the partial disclosure is misleading. We believe the market should have such additional information in order to assess the interests of the various parties involved in the bid and in the expanded offeror company if the bid should succeed.

How Rimibo Resources Limited Was Floated

After the discussion in the first part of this chapter of practices associated with a strongly sought flotation issue, we turn, in this third case-study, to an example of the disturbing consequences that can arise from the underwriting of a flotation which fails to win public support. The flotation that we now consider is that of Rimibo Resources Limited.

We have described in Chapter 7 how, through the flotation of the company called Selected Mining Holdings Ltd, the Melbourne investment consultancy business of Australian Investment Counsellors Pty Ltd (A.I.C.) had expanded the volume of funds within its influence by about two million dollars. Shortly after the listing of Selected Mining Holdings in November 1970, A.I.C. saw an opportunity of increasing further the cash resources with which (we can say in retrospect) it would be able to play the share market, or which it could pass over to brokers for the same purpose. This next step involved using Selected Mining to acquire what Major Douglas (the chairman of Selected Mining and principal of A.I.C.) regarded as a 'controlling' interest (Ev. 2470) in another public company, Rimibo Resources Limited, which issued a public prospectus in Melbourne in November 1970 to raise $750,000. When we began examining this transaction - a transaction that took place well after the establishment of this Committee and at a time when the boom was collapsing - it was not with the intention of extending the inquiry. However, as the investigations proceeded, evidence was obtained of the failure of the directors of two listed companies to meet their public responsibilities. In addition, we came upon what appeared to be unavoidable indications that an underwriter had overlooked his obligations as a member of a stock exchange when his personal financial interests were threatened, and had been able to do so without challenge from any regulatory authorities.

Changes in a Prospectus, Undisclosed to the Market

Rimibo Resources Limited was incorporated in Victoria on 27 October 1970, and the prospectus for the issue of three million shares (carrying rights to 1.5 million options) at 25 cents each was dated 11 November 1970. The underwriter was Richard Parsons & Company, the firm through which Mr Richard Owen Parsons traded as a member of the Melbourne Stock Exchange. Mr Parsons was also a director of Rimibo. The underwriting agreement (signed on 28 October 1970) provided that 'within thirty-one days after the registration of the prospectus' (which took place in Victoria on 17 November 1970) the underwriter would provide applications accompanied by payment in full for the whole of the issue amounting to $750,000. Of the three million shares involved, Mr Parsons said he had arranged for the sub-underwriting of only 895,000 shares. This meant that any shortfall in the public's subscriptions for the shares on offer had to be made up mainly from Mr Parsons' own financial resources.

If the market demand for such flotations had continued at its earlier feverish level, public subscriptions for the shares could have been expected to be readily forthcoming, and it was presumably in the expectation of such a favourable market that the underwriter had obtained the right under the underwriting agreement to 'the firm allotment of the whole of the issue ... for applicants nominated or approved by the underwriter'. In other words, if the market demand were so great as to require the rationing of the shares among the applicants, the broker-underwriter would decide upon the allocations. The underwriter's commission was shown in the prospectus as one cent a share, amounting to $30,000, from which brokerage amounting to .3 of a cent a share was to be paid to members of the exchange who arranged subscriptions to the issue. By the time the prospectus was available on the market, however, well after the signing of the underwriting agreement, the public demand for such securities had become almost satiated, and Mr Parsons found that some of his clients who had earlier indicated that they would subscribe to Rimibo were no longer willing to do so. In his words:

... as the time moved along towards the end of December, nervousness was very strong in the market, and quite a number of people who had requested shares in the company, every day of the week as time went on, were getting a little bit more nervous, and they were starting to cut down, or ring up and say they thought they would only have half ...

(Ev. 2427)

In particular, one of Mr Parsons' clients whom he had expected to take up one million shares, failed to subscribe. At a meeting on 3 December 1970 the directors referred to the low level of public subscriptions, and the question was raised as to the underwriter's liability to the company. The minutes recorded the discussion as follows:

During discussion Mr Marriott [the company's solicitor] advised that he considered that the company could not withdraw the prospectus. The underwriting agreement with Mr Parsons was a contract which could not be varied prior to the statutory meeting of the company.

(Committee Document 11-19)

The chairman of the company at the time, Mr K. R. Farfor, has informed us that he had 'raised the question of the liability which the underwriter had to the company' in view of his and other directors' doubts about whether the level of subscriptions would increase (Committee Document 11-20).

Following the underwriter's failure to obtain the large subscription for one million shares, negotiations proceeded with another party, Selected Mining Holdings, for an application of a similar size. Subsequently the directors and underwriter of Rimibo met with three directors of Selected Mining, Messrs Douglas, E. E. Falk, and A. W. Muddyman. This meeting took place at 8.30 during the morning of 17 December 1970, the day before the date on which, according to the underwriting agreement, Mr Parsons had agreed to provide subscriptions for three million shares. A memorandum of the meeting obtained by the Committee (Committee Document 11-21) records that the Selected Mining directors made an 'offer' on behalf of that company to apply for 1.2 million Rimibo shares to be issued in three different nominee names (one being the nominee company of the underwriting broker), on the following seven conditions:

1. The present Board not to vary the financial structure of the Company.

2. Mr E. E. Falk to be appointed Secretary of Rimibo Resources Limited and Grant & Falk to take over the share register of Rimibo at a time to be decided by the Directors; at the present time it is intended that this should be at the time of the statutory meeting.

3. Australian Investment Counsellots Pty Ltd to be appointed forthwith as manager and investment consultant of Rimibo upon the following terms:

(a) 5 years initial term, renewable thereafter annually, initial term not terminable except for fraud or gross incompetence on Australian Investment Counsellors' part;

(b) Remuneration to be management expenses of $15,000 per annum plus ¼% of the market value of the investment fund annually;

(c) Australian Investment Counsellors' duty to be to provide all investment advice and services, and clerical and executive services not provided by the Secretary and his office. We consent to Australian Investment Counsellors' engagement with Rimibo.

4. A Director of Selected Mining Holdings Limited to be a counter-signatory to Rimibo's bank account forthwith after full proceeds of issue are deposited with Rimibo's bank, which must be by Thursday 24 December, 1970.

5. Up to three representatives of Selected Mining Holdings Limited to be entitled to attend all Board meetings of Rimibo until Selected gets Board representation on the Rimibo Board.

6. There to be at least 200 applicants to the issue.

7. Rimibo to do all things necessary to apply and obtain listing.

The memorandum also records the Rimibo directors and Rimibo underwriter as accepting the 'offer'. On the same day, Selected Mining Holdings' solicitor (who Mr Parsons thought was also acting for Rimibo and himself, see Ev. 2433), wrote a letter to Richard Parsons & Company setting out the seven conditions on which Selected Mining was applying for the shares (Committee Document 11-22). At a meeting of the directors of Rimibo on 17 December, with three of the directors of Selected Mining in attendance (and also at 8.30 during the morning according to the minutes) it was agreed to allot the 1.2 million shares to Selected Mining and to enter into a management agreement with A.I.C. (Committee Document 11-23).

While the Rimibo directors and underwriters were soliciting funds from the public in the open capital market by means of a prospectus, they therefore agreed to accept a large subscription on terms which involved a number of fundamental changes affecting the direction and management of the company. On the basis of this arrangement, Selected Mining directors could veto decisions of the Rimibo board by not signing their cheques, and the Rimibo board agreed not to vary the company's financial structure, which presumably prevented the issue of new shares that could dilute Selected Mining's holding. In addition, it was agreed that Selected Mining representatives could attend all Rimibo directors' meetings, thereby having full private knowledge of the company's affairs. Also, according to Mr Parsons, the Rimibo board agreed to change its own composition by appointing three Selected Mining representatives to replace some existing members (Ev. 2423). Furthermore, the management of the company was to be different from that set out in the prospectus, as Selected Mining's manager, A.I.C., was to be appointed for a five-year term. Individually, each of these conditions amounted to a significant alteration to the information presented in the prospectus. Collectively, they had the effect of transferring control of Rimibo to a group of persons whose names were unknown to the public subscribers to the flotation. Those members of the public who had already applied for the shares on the basis of the prospectus had done so under circumstances which were now markedly changed. They should have at once been given an opportunity of reconsidering and, if they wished, withdrawing their subscription~ Those investors (including the brokers who had apparently sub-underwritten part of the issue) who were trying to make a rational assessment of the new company's prospects, and looking to the prospectus as the guide on the soundness and likely success of the venture, were now lacking essential information. Major Douglas, who said he had arranged the foregoing transaction for Selected Mining, was under no doubt at the time about the importance of the agreement to him and to Selected Mining. In evidence in camera he told us that he believed he had not only gained control for Selected Mining, but that he had brought off a coup: he described the expenditure of $300,000 for the controlling interest in the $750,000 company as 'a two for one value on money expended, and I considered that to be a good move'. He also described the actions as 'a normal operation within the market'.

However, subscribers to the Rimibo prospectus were not given any opportunity to reconsider their investment decision, for the next day, 18 December 1970, the directors announced that the underwriter had closed the issue. Moreover, the stock exchanges were not advised of the circumstances of Selected Mining's application and the special terms agreed to by Rimibo.

When Mr Parsons appeared as a witness before the Committee, he confirmed that the Rimibo directors had agreed to the conditions demanded by Selected Mining in exchange for their subscription to 40 per cent of the Rimibo public issue (Ev. 2421), and he also showed an awareness of the details and implications of the various clauses (Ev. 2422-23 & 2427). While giving this evidence, however, he also maintained that at the directors' meeting on 17 December 1970 called to settle the terms of the subscription 'we were not discussing any matters that could possibly affect the shareholders' (Ev. 2423). Mr Parsons remained of the opinion that the acceptance of Selected Mining's terms of 17 December 1970 did not amount to material alterations to the control, management and structure of the company as set out in the prospectus, and he did not believe that the subscribers were entitled to this information (Ev. 2428-29). As we have already indicated, we strongly disagree with Mr Parsons in this matter, and we find it most disturbing that a member of a stock exchange and underwriter of public issues should have held his views.

Mr Parsons also introduced another argument: he said that the terms of the agreement were never 'carried out', and that although Selected Mining directors were permitted 'to come to meetings and so forth, they never did' (Ev. 2423). As events turned out, after Major Douglas and the other directors resigned from the Selected Mining board in late January 1971, the new directors did have difficulty in trying to obtain control of Rimibo's assets, and the Rimibo board did not carry out certain of the provisions in the agreement. However, some of the provisions were implemented, and on at least three occasions (17 December 1970, 5 January 1971 and 25 January 1971) Selected Mining's directors were recorded as attending Rimibo Resources' directors' meetings (Committee Documents 11-23, 11-24, 11-25). At any event these subsequent developments are hardly relevant to the question of what the public should have been told at the time the Rimibo prospectus was on the market.

When Major Douglas was asked why there was no public announcement of the agreement between Selected Mining and Rimibo directors, he replied:

The disclosure that one company was to take a major position in Rimibo Resources Ltd may have prejudiced its flotation and could have been contrary to the interests of subscribing shareholders at the time the shares were listed.
Also, at the time, there were indications of a market raid of Selected Mining Holdings Lid shares by a group, which in the opinion of the Selected Mining Holdings Ltd directors, placed the interest of shareholders last in those companies which it attacked. This rendered it in our judgment desirable for the Selected Mining Holdings Ltd directors in the interests of their shareholders, to conceal from the raider as long as they could, the fact that Selected Mining Holdings Ltd would have control (through

Rimibo Resources Ltd) of substantial liquid funds, which would have been an added attraction to any raider intent on siphoning off liquidity to its own advantage.

(Committee Document 11-26)

This calls for some comment. Major Douglas was not technically a director of Rimibo, though his group had acquired effective powers over the operations of the company which overrode the power of its nominal directors. Major Douglas' responsibility to investors in Rimibo, and his duty to inform them of the facts relating to that company, may be a matter of legal debate, even though the fate of their investments rested mainly in his hands. But in the above statement Major Douglas is not only cheerfully explaining the secrecy on grounds that a frank announcement could have deterred Rimibo subscribers and reduced the size of the cashbox that would fall into his hands, he is also denying that in his undisputed capacity as a director of Selected Mining Holdings he had any obligation to inform the shareholders of that company of the substantial change in its affairs as a result of its acquiring a 40 per cent interest in Rimibo. The entire statement shows a cavalier disregard for the first principle on which prospectuses and share markets should be based - full and frank disclosure.

In our view, there was another reason why the directors of both companies withheld information on what was happening. If there had been an announcement of the special terms on which Rimibo shares were issued to Selected Mining, the question would surely have arisen whether the Melbourne Stock Exchange should have refused listing of Rimibo (even though the prospectus said that the Exchange had agreed to list the company's shares); and it was a condition of Selected Mining's subscription, bailing Mr Parsons out of a grievous predicament, that Rimibo 'do all things necessary to apply and obtain listing' (Committee Document 11-21). We also note that on 2 December 1970, about two weeks before the agreement with Selected Mining, when another investing company had allegedly been willing to make a large subscription to Rimibo on condition that it obtain board representation, the Rimibo directors recorded in their minutes that they would not accept such terms, on the grounds that to do so would have amounted to a material alteration of statements in the prospectus (Committee Document 11-27). In the case of Selected Mining's subscription, the Rimibo directors and underwriter agreed to a range of conditions that were more restrictive and objectionable than those which they had apparently turned down two weeks earlier.

Although the full details of the terms of Selected Mining's subscription were concealed from the public, some of the conditions could not be kept secret, and following the closure of the Rimibo prospectus there was a partial release of information when, on 18 December 1970, Selected Mining said it had acquired 'for $300,000 cash, shares constituting a minority interest in a company'. According to Major Douglas, the statement deliberately did not say that the shares had been bought in Rimibo (Ev. 2469). Moreover, the Rimibo share register would not have revealed the extent of Selected Mining's ownership, as the shares were held in the names of nominees. An inquiry by the Melbourne Exchange on 5 January 1971, brought forth a reply from Selected Mining on 6 January 1971, that the 40 per cent shareholding was in Rimibo. But the directors still spoke of this holding as a 'minority' one. In a technical sense this might have been true; but as we have seen, the directors themselves regarded it as carrying control of Rimibo. No further information was given to the stock exchange. Next on 7 January 1971, when Rimibo's shares were listed, the Melbourne Exchange was informed by Rimibo of the appointment of A.I.C. as investment managers, but there was no reference to the agreement of 17 December 1970. Thus about 390 members of the public, including clients of the broker-underwriter, who subscribed to the Rimibo issue (197 of whom each invested $250 or less), never did learn how, on 17 December, after their applications had been made but before the closure of the prospectus, the board of Rimibo had agreed to abdicate the most essential powers for the running of the company and, to a large extent, to become figureheads.

Self-Protection by the Broker-Underwriter

Together with Selected Mining's subscription of 1.2 million shares, about 2,460,000 shares were taken up by the public in the Rimibo issue, leaving a 'shortfall' of 540,000 shares. Thus if Selected Mining had not taken up 1.2 million shares, the 'shortfall' would have been 1,740,000 shares, and subscriptions for these shares would have had to be provided by Richard Parsons & Company as the underwriter of the issue. As we have said, this firm had apparently made some arrangements with a number of brokers whereby they, as sub-underwriters, would ensure that subscriptions would be forthcoming for up to 895,000 shares in such circumstances. Thus Richard Parsons & Company would not have had to subscribe for the entire 'shortfall' of 1,740,000 shares. The Committee asked Mr Parsons for copies of the letters from the sub-underwriters in order to find out the details of the arrangements he had entered into, but his reply was: 'These cannot be traced in the file ...' (Committee Document 11-28). So we do not know the precise number of shares Richard Parsons & Company would have had to take up if the special subscription had not been obtained from Selected Mining. However, the total would not have been less than 845,000 shares, costing $211,250.

In correspondence with the Committee Mr Parsons agreed that his liability to take up shares if Selected Mining's subscription had not been forthcoming would have been 1,740,000 shares, for only part of which sub-underwriting arrangements had been made. However, Mr Parsons also seemed to believe that he could have financed the resulting commitment. We have had difficulty in understanding his reason for believing this, but it appears to be based on his knowledge of the investment requirements of his clients which he had 'prior to agreeing to act as underwriter' (Committee Documents 11-29, 11-30, 11-31). Yet as Mr Parsons himself said, by 17 December 1970, investors were 'nervous' and an increasing number who had indicated that they would subscribe were changing their minds. In our view the float would not have succeeded through further public subscriptions. Collectively, the public investors had largely rejected the issue. The company chairman's address to shareholders in November 1971 also said that the allotment of 1.2 million shares to Selected Mining Holdings had been made 'in order to avoid a shortfall in share applications on the floating of the company'. At any event, time had run out; there was no further opportunity to seek public subscriptions. Mr Parsons himself referred several times to a 'deadline' (Ev. 2427), and the date on which he had undertaken as underwriter to provide the full subscription was 18 December, the day after the arrangement with Selected Mining. Had there been no such arrangement with Selected Mining, the float could only have succeeded as a result of the underwriter subscribing for shares costing more than $200,000. In our judgment, after examining the relevant records, the financial resources of the broking firm would not have been sufficient to meet this commitment. We also believe it unlikely that sufficient funds could have been borrowed by the underwriter on acceptable terms to take up the shares. But even if such funds could have been obtained, the fact that the shares which were issued at 25 cents each were first quoted at 20 cents, and had fallen to 10 cents within two months would have involved the broker in a large loss. If the Rimibo directors and underwriter had not agreed to the Selected Mining 'offer' at that late stage on 17 December 1970, one of the directors would, as the broker-underwriter, have been placed in a perilous financial position. In agreeing to the Selected Mining 'offer', and to the decision not to make this public, Mr Parsons must have known of the heavy financial losses, amounting to a grave crisis, he was thereby avoiding for himself. In our view the interests of the broker were placed before his responsibilities and obligations as a director and member of a stock exchange. The consideration of his own financial plight resulting from an error of judgment on his part led him to compromise the position of investors and his clients whom he had encouraged to invest in Rimibo while concealing from them the changes in the control and management of the company.

Stock Exchange Regulation

When carrying out this inquiry, one of the main questions which concerned the Committee was whether the Stock Exchange of Melbourne took any action to see that Mr Parsons could meet his commitment as an underwriter. Mr Parsons said in his evidence that 'the chairman did ask me to go down to see him'. In Mr Parsons' words: 'the discussion revolved around the matter of whether I could handle the underwriting, and I said yes, I could; and that was all that was said' (Ev. 2434). Sir Cecil Looker, the chairman of the Melbourne Stock Exchange, supplied us with copies of the minutes of the Exchange committee relating to the Rimibo underwriting, and we quote them in full as an example of the Exchange committee's regulatory methods.

17th November 1970

Some Committee Members advised that they felt concern as to the underwriting of the issue of Rimibo Resources Limited of $750,000 [of] ordinary shares of 25 cents each, to which approval of the Unconditional Listing Paragraph was given at last week's Committee Meeting.

It was noted that Messrs Richard Parsons & Co. had underwritten the issue (the issue not being taken firm) and that it was known that sub-underwriting offers to Member Firms had been refused by several Member Firms.

It was resolved that the Vice-Chairman speak to the Underwriter as to the current underwriting position.

24th November 1970

The Vice-Chairman reported that he had spoken to the Underwriter who is confident that he can meet his obligations in respect of this issue.

It was resolved that the Chairman would follow this up now that the issue has been opened to see what the current position is and whether it warranted any further action.

1st December 1970

The Chairman reported that he had spoken to the Underwriter who expressed the opinion that the issue was not going as well as expected. However, he expected that the position would be fully covered. If this is not the case he has undertaken to contact the Chairman.

22nd December 1970

The Chairman advised that Mr Parsons of Richard Parsons & Co. had stated that any shortfall arising from the issue of Rimibo Resources was covered.

The Committee resolved that no action was required.

It can be seen that after some concern was expressed at a stock exchange meeting on 17 November 1970 about a member firm's underwriting of the Rimibo issue, the action taken was for the vice-chairman to 'speak to the underwriter' and report back one week later that the underwriter was 'confident' he could meet his obligations. Two further discussions took place with the underwriter of a similar nature over the next four weeks, and on each occasion the stock exchange was satisfied with the answers that the issue 'would be fully covered' or 'was covered', and that the broker had 'undertaken' to contact the chairman if that was not the case. This method of regulation by a body with public responsibilities and quasi-judicial powers smacks of clubbism. A matter had arisen which could be serious concerning the ability of a broker to meet a large underwriting commitment, and it was not sufficient to rely upon interviews and questioning when investigating the matter. As we were to find in the course of our inquiries, the broker's records and sub-underwriting agreements (if they could be discovered) needed to be examined in detail. We realise that the stock exchange could not have investigated the records of the Rimibo and Selected Mining companies, which would have made it difficult for the exchange to obtain documentary evidence of the improper agreement between those companies on 17 December; but that does not explain why it failed to investigate and regulate its own member. Again, the evidence points to the need for a government body which will ensure that members of stock exchanges, and companies which use the stock exchange markets, are subject to rigorous investigatory and regulatory procedures.

The Real Purpose of the Flotation

According to the Rimibo prospectus, the company was formed 'with the principal purpose of assuming a role in the development of Australia's natural resources'. The chairman also said in that document:

Specifically the company's principal objectives are as follows:

To participate directly in mining or other extractive or exploration projects.

To participate indirectly in mining or exploration ventures through investment of shareholders' funds in listed securities.

To assist in the promotion and financing of companies or projects either through the provision of loans, equity funds or expertise.

After a general description of the boom in mineral exports, and the large expenditure on exploration in Australia, the report continued:

Within this framework of heavy investment in the various facets of the natural resources industries, and in a climate of significant earnings from mineral wealth, it is anticipated that attractive opportunities will arise for the participation of Rimibo Resources Limited. It is the intention of the Board that the Company should participate directly, or jointly, in exploration or development projects with the ultimate aim of producing assured long term cash flows for the benefit of the company and its shareholders.

The first mention of sharetrading then followed:

In the initial phases of the company's existence it is anticipated that funds surplus to immediate requirements will be invested in listed securities. In a share market closely dependent on developments in the exploration or production phase, the shares of many listed companies customarily swing from short term undervaluation to overvaluation and vice-versa, creating opportunities for worthwhile capital gains. It is intended to take advantage of this market climate to build up the value of shareholders' funds by successful share trading. Additional income is expected to be earned from the writing of put and call options against securities held in the Company's portfolio. This activity, together with interest and dividends received, is expected to be sufficient to defray the day-to-day running and administrative costs of the company.

In spite of these fairly sober, cautious statements, on 5 January 1971, two days before the shares were first quoted on the exchanges, the directors met with the company's new investment consultants (A.I.C.), and decided on the following 'short-term investment policy':

(i) The company initially concentrate on an aggressive share trading with a view to building up shareholders' funds.

(ii) The manager subject to the abovementioned restrictions be hereby given authority to invest up to $400,000 in the stock market in the manner the manager considers appropriate.

(iii) The Manager be empowered to write and trade in the option market up to a limit of $100,000.

(Committee Document 11-24)

Thus, just after closing of the public issue, the directors resolved to commit up to $500,000 of the $750,000 raised in share and option trading, an activity not specifically mentioned as one of the company's three principal objectives. In the first six months of operations to June 1971, share-trading purchases amounted to $354,000, of which $146,000 was through Richard Parsons & Co. Most of this trading was in 'speculative-type shares', according to a report to the shareholders by a new chairman of the company on 29 November 1971. The company also spent $137,000 buying 1,119,000 Selected Mining Holdings shares which the directors classified as an 'investment'. However, in view of Selected Mining Holdings' activities (which we have discussed at length in Chapter 7), Rimibo's purchases of these shares could only be described as highly speculative. Mr Parsons' explanation of why the directors had used the company's funds for share speculation rather than for carrying out the principal objectives set out in the prospectus was:

... because the Chairman's statement was dated 28 October 1970, and by the time the company got off the ground it was into January [1971], and conditions were very, very much different then from when this statement was written. This was the genuine intention of the directors and the company, but things were very different by the time we started to run them.

(Ev. 2434)

In our view this explanation only shows how much the directors were concerned with gambling in share scrip, for the change that took place in those three months to January 1971 was not a change in Australia's potential for real development in the mineral industry, but the collapse of inflated share prices and a severe falling off in share-trading and brokerage commission business.

By June 1971, of the $750,000 raised in Rimibo's public issue about seven months earlier, approximately $210,000 had been lost, mostly on the holding of Selected Mining shares and from share-trading. By comparison, only $6,477 had been spent on investigating mineral claims. There seems to have been no serious attempt to use the company funds 'in the development of Australia's natural resources' - the principal purpose of the flotation, according to the public prospectus.

Why Devex Limited Was Floated

The fourth case-study of this chapter is concerned with some aspects of the affairs of Devex Limited. We found that the objectives of the company as set out in the prospectus bore small resemblance to the real intentions of the promoters, directors and one of the underwriters. Although the prospectus gave little information which would assist an investor to make a rational assessment of the company's prospects, the general impression gained from reading the document was that the capital was being raised for investment in the development of the mineral industry. As we will show, practically all the funds raised in the flotation were directed into stock exchange speculation largely through one of the underwriting brokers. The evidence also shows how, only several months after the flotation, at a time when the directors and underwriting broker knew the company's share price was artificially inflated, they rapidly carried out a private placement of a substantial number of new shares without explaining that the additional funds raised in this way were also to be used in stock exchange speculation. Our investigations also produced other evidence on the attitudes of two of the company's directors who believed they could freely, and without challenge, either ignore stock exchange listing requirements or abide by them at times of their own choosing.

The Prospectus

The prospectus of Devex Limited was dated 27 July 1970, and it offered 999,993 shares of 50 cents each for public subscription, with two Sydney brokers as the underwriters, Hattersley and Maxwelland Garrett Lance & Co. Two former employees of these broking firms, Mr Warwick Harding Jones and Mr Sydney James Howe Wills, were both the Devex promoters and also two of its directors. While working for the brokers, Messrs Jones and Wills had been active share traders (a 'common practice' among brokers' staff, according to Mr Wills, Ev. 2580), and had built up substantial profits before leaving to engage in other activities in the securities markets. Of the shares offered in the prospectus, about 350,000 were taken up by Messrs Jones and Wills or their nominees, partly with funds lent to them by the underwriter~ Messrs Jones and Wills told the Committee that when they first suggested floating the company in 1970, the brokers had discouraged them from doing so on the grounds that market conditions were not favourable. Later, however, when market prices had begun to rise again, the brokers had offered to underwrite the issue. By this time Messrs Jones and Wills had committed part of their own funds elsewhere, so they accepted financial assistance offered by the underwriters to enable them to take up the large numbers of shares reserved for them in the issue (Ev. 2578-79). Messrs Jones and Wills were shown in the prospectus as having bachelor degrees in economics from Sydney University, and Mr Jones also had a masters degree in science (mining) from London University. Mr Jones described himself as a mining consultant, and Mr Wills as a mining investment consultant. In addition to being directors, they had entered into an agreement with the company to manage the business for three years, and under this agreement they were granted an option to take up 50,000 shares each at par.

The prospectus set out the company's objectives as follows:

Devex Limited ("the Company") was incorporated at the instigation of the managers, to take advantage of opportunities to provide financial assistance or managerial expertise in the establishment of mining ventures, sub-underwriting of mining ventures and the investment and trading in shares listed on any member Stock Exchange of the Associated Australian Stock Exchanges of companies engaged in the developing and exploitation of Australia's natural resources.

No titles to mineral prospects were held at the time, and there was no further information on how the company might go about its business. There was no information at all about the previous business experience of Jones and Wills, other positions they had held, or why they believed they could provide financial and managerial expertise for other companies. There was no mention of a consulting geologist. The prospectus listed in the customary way the company's bankers, solicitors, auditors, and solicitors to the underwriters; but the formal listing of such names is of little or no assistance to investors in assessing the ability of the company's directors and managers to run a sound enterprise. In summary, there was an obvious absence of relevant information to assist investors to make a reasonably informed judgment about the company's future. Nonetheless, the prospectus was readily registered in New South Wales (Ev. 2576); it must also have passed the scrutiny of the Sydney Stock Exchange, for the directors said in the prospectus that the shares had been admitted to the official list of that Exchange. This particular prospectus was only one among many that came to our notice as lacking relevant information. Another example was the prospectus of Barewa Oil and Mining N.L., which was discussed by the Committee with the Acting Registrar of Companies in Western Australia. He agreed that although a prospectus might meet the requirements of the Companies Act that did not necessarily mean it would enable members of the public to make a reasonably informed judgment as to whether or not they should invest in the company (Ev. 225).

The Real Purpose of the Flotation

In testifying before the Committee Mr Wills agreed that at the time of the Devex flotation 'it was ... somewhat nebulous as to exactly what [the company's] activities would be, within the general confines of the concept outlined in that broad statement of the chairman' (Ev. 2576). However, on one matter there was no doubt: both Mr Wills and Mr Jones were sure that, from the beginning of the venture, share-trading would be the most important activity. Mr Wills expected it to account for 'around 50 or 60 per cent' of the business (Ev. 2577), but Mr Jones thought it was to have been even greater:

When we started off, I think the intention was to have the major part of our assets - if you asked me to define major I would have said, say, 80 or 90 per cent of our assets - in share investments. But the market got so carried away, that what was an investment and what was trading was often very difficult to distinguish. Certainly, if you asked me on a theoretical basis, I would say roughly 50-50 share-trading and share investment.

(Ev. 2577-78)

Once again, the prospectus failed to disclose how the directors really intended to use the public's funds.

When Mr John Preston Crothers, a partner in the underwriting firm of Hattersley & Maxwell, appeared before the Committee, he not only indirectly confirmed the above views of the promoters but made clear the obvious attraction of such floats to stockbrokers:

Mr Crothers: My personal enthusiasm for the float was unbounded.

Senator Georges: When was this?

Mr Crothers: July 1970.

Senator Georges: When did Minsec [Mineral Securities Australia Limited] come into operation? It seems to me that this sort of operation, in the nature of an advising group or an investing group, may have led to the establishment of funds similar to the Minsec group. Would that be so?

Mr Crothers: Exactly.

Senator Georges: And was it established around about the same time as Minsec, or subsequent to Minsec?

Mr Crothers: Minsec had been going for three or four years.

Senator Georges: Three or four years. And the anticipation of the establishment of this group was based on the success of Minsec and other similar organisations?

Mr Crothers: That certainly is the feeling I have.

(Ev. 2568-69)

The great interest of the stockbroker in having a close association with a Minsec-type company scarcely needs explaining. Minsec was a massive share trader, capable of generating enormous brokerage incomes for stockbrokers, and Hattersley & Maxwell had seen at first hand the scale of Minsec's dealings as the firm had carried out huge Robe River share transactions for the Minsec group of companies. Mr Crothers himself referred to a sum of $20 million as being Mineral Securities' net profits up until June 1970, and he went on to say: 'That certainly had expanded our imagination of what sort of profit could be made by a Minsec-type operation. I envisaged Devex as perhaps being the beginnings of a Minsec-type company ...' (Ev. 2570). Mr Crothers also reiterated to the Committee the view, commonly expressed during the boom years, that the means by which a company such as Devex should establish itself as the head of a mining group was by accumulating profits from share speculation and then taking over other companies. At the time of the Devex float he had thought that 'Mineral Securities was moving towards becoming a miner in its own right. That was its object, or seemed to be' (Ev. 2570). Although the partners of Hattersley & Maxwell saw clearly the advantages for them in sponsoring and underwriting Devex, and even though they might also have explained to their clients how they expected Devex to follow in Minsec's footsteps, they did not arrange for this information to be expressed in the prospectus.

How the Capital Was Spent

Having received about $500,000 in the flotation, the Devex directors elected to pursue what was at the time probably an even more risky objective than playing the market generally; they concentrated their activities on buying the shares of Selected Mining Holdings. This plan began with a subscription for 50,000 shares in Selected Mining Holdings at the time of the public issue; then, when the shares were first quoted on the exchanges at prices considered to be below their cash asset backing, further large parcels of shares were bought at prices between 14 and 16 cents. The intention at this stage was to trade in the shares, but soon the objective became one of trying to acquire effective control of the company in order to bring within the management of Devex the approximately $2 million of cash raised in the Selected Mining flotation. In Mr Wills' words, it was a means 'of gearing up $500,000 into $2 million' (Ev. 2583). In pursuit of this aim Devex bought on most trading days through November and December, mainly through Hattersley & Maxwell, until it held about 36 per cent of the shares and 20 per cent of the options.

Selected Mining (but not the stock exchange) was informed of these large purchases by Devex (amounting to 24 per cent of the shares and 10 per cent of the options at the time) on 10 December 1970, and the next day this notification was followed by a request that the Selected Mining board be reconstituted to allow Devex representatives to hold the majority of the appointments. On 15 December, Devex notified Selected Mining (but not the stock exchange), in writing, of its holdings (which now amounted to 32 per cent of the shares and 20 per cent of the options), and again asked for a change in the board. At this stage, Devex had spent most of its funds on the purchases and, in Mr Wills' words, was 'running a little short of money' (Ev. 2587). Before giving notice to shareholders or to the stock exchanges of how the company's recent cash raising had been used, and without saying why the company required further capital, the Devex directors immediately arranged on 17 December for the placement of 100,000 new shares at $1.00 a share. According to Mr Wills, this placement was 'just in case defensive measures were taken[by Selected Mining~ which would necessitate our buying further significant shares on the market' (Ev. 2587).

When the Committee asked why the Devex directors had not followed the requirements of the A.A.S.E. List Requirements, Section 3,A(12), and immediately disclosed to the exchanges the significant acquisition of shares in Selected Mining, both Mr Wills and Mr Jones said that in their view as directors it had not been in their shareholders' interest to make this announcement before 18 December. Neither Mr Wills nor Mr Jones thought there was anything wrong in this behaviour; they both believed that the directors should determine what was in the shareholders' interests and ignore the stock exchanges' List Requirements if they judged it in shareholders' interests to do so (Ev. 2590). Mr Wills also said that he had never been queried about the delay, but he assumed that the stock exchange committee had known of Devex's purchases and of the delay in notifying them formally, as one of the committee members was the senior partner of the broking firm that was advising Selected Mining (Ev. 2590-91).

The funds from the placement of 100,000 shares were quickly spent on buying further Selected Mining shares, and on 30 December the Devex directors placed an additional 150,O00 shares at 85 cents each. This quick disposal of 250,000 new Devex shares, at relatively high prices, through the brokers Hattersicy & Maxwell and Garrett Lance & Co. followed a period of about two weeks when Devex's share price had risen from 80 cents to $1.20. In explaining this sharp rise to the Committee, Mr Crothers of Hattersley & Maxwell said that it was owing to a market newsletter ('the most extraordinary publication I have ever read about') written by an investment consultant and reported in the Press as saying that Devex shares could be worth $750 each on the basis of the company's interest in diamond exploration in South West Africa (Ev. 2572). Mr Crothers and the Devex directors knew of this irregular and passing influence on the share price, and they recognised an element of fantasy in the newsletter's forecast; nevertheless, they did not hesitate to place new shares with the public at these high prices, raising a large amount of capital compared with the existing size of the company. The funds from the second placement were also used immediately for the purchase of Selected Mining shares, again mainly through HattersIcy & Maxwell.

When Mr Wills of Devex was giving evidence to the Committee, he said that he believed this extraordinary speculative attempt to 'raid' Selected Mining Holdings 'fell completely within our aims' (Ev. 2581). Our view is that if this were so, the prospectus failed to make those aims clear. The prospectus of Selected Mining Holdings had shown that the company held no mineral prospects~ so that the Devex directors had no reasonable grounds for believing Selected Mining was engaged in the 'developing and exploitation of Australia's natural resources' - the type of company in which, according to the Devex prospectus, shareholders' funds were to be invested. Moreover, the Devex prospectus gave no indication that practically the entire resources of the company, amounting to over $700,000, might be put at risk in the one speculative transaction. In the result, the directors failed to achieve their main objective of obtaining control of Selected Mining. They were fortunate, however, in selling all the shares in January 1971 for a profit of about $55,000, after which, according to the evidence, Mr Wills 'slept soundly for a week' (Ev. 2589). But with the rest of the share-trading this luck did not hold, and share-trading losses to 30 June 1971 came to about $145,000. According to the 1971 accounts, of the $727,500 raised from the public during the preceding ten months, $121,797 was lost, mainly through share-trading.

CHAPTER 12
THE IRRECONCILABLE CONFLICTS OF AN OPTION DEALER

The Option Brokers Association

The purchase and sale of 'put' and 'call' options by and through a fairly large number of option dealers was an active daily business during the period of our inquiries, and we sought our first evidence in this area of the securities markets from the chairman of the Option Brokers Association, Mr K.G. Donaldson. He told us that since 1964 when the Association had been formed, there had been a large expansion in the volume of option dealing with many investors, share traders, stockbrokers and institutions making use of the facilities, especially during the mineral share boom. According to Mr Donaldson, in the two years to March 1971, the volume of business had trebled (EVo 1083). Extensive advertising by option dealers had accompanied this expansion of business, and presumably it was in this way that many investors first became aware of the market's existence. Although members of the stock exchange were permitted to deal in options with members of the Option Brokers Association, they were not themselves permitted to be members of the Association. Stockbrokers were also permitted to make a market in options on the exchanges which did, in effect, compete with the market provided by the Association, but generally the greatest volume of business was done by the members of the Association.

Not all option dealers were members of the Option Brokers Association, but Mr Donaldson said that the Association had ten members who had met the entry requirements which included having a capital of $25,000 and being 'a fit and proper person' (Ev. 1075 & 1079). Mr Donaldson appeared before the Committee in March 1971, and when he was asked if there had been any State government legislation directed at the activities of option dealers or covering the operations of the Option Brokers Association he said: 'Unfortunately, no' (Ev. 1081). He explained, however, that the Association itself tried 'to regularise' certain activities of its ten members, such as the charging of commission (Ev. 1076). Mr Donaldson thought that the abuse which should be especially guarded against was that of an option broker 'receiving the premium on the one hand but not making any provision to supply the goods [shares] on the other hand' (Ev. 1079). As we shall shortly show, it was by failing to deliver shares bought and paid for under an option contract that a member of the Option Brokers Association involved the shareholders of two public companies in large losses. In reply to the Committee's questions, Mr Donaldson said that the Association had no staff involved in regulatory activities, and had only a small budget sufficient to cover clerical and basic administrative needs (Ev. 1079). The fines for members failing to observe the Association's rules were 'very minimal' (Ev. 1076).

It was not the Committee's function to consider what long-term role the option market has in Australia. We have noted, however, that in several leading capital markets such dealings have become part of the normal operations of the securities markets, which suggests that such dealings may be expected to continue in Australia, though with considerable fluctuations in the level of activity.

After receiving evidence from the Option Brokers Association, the Committee sought information from Dr Michael Duhan Garretty on his former option dealing company, Stock Options of Australia Pty Ltd, as well as on other aspects of Dr Garretty's businesses which were relevant to our inquiry. Dr Garretty had introduced option business into Australia in the early 1960s, and he had subsequently formed the Option Brokers

Association. Our purpose in carrying out this study of one member of the Option Brokers Association was to see how, in practice, self-regulation had been working among the option dealers. Although we have been disturbed by the evidence we present in this chapter, we must make it clear that we are not suggesting that such practices were known to or would have been countenanced by other members of the Option Brokers Association. An additional purpose of our inquiry was to find out what procedures, if any, the State government regulatory authorities had followed in monitoring activities in this area of the securities markets. The reason for extending the investigation beyond the immediate affairs of Stock Options of Australia was that, after this company was formed in 1960, it became an integral part of a group of proprietary companies which were also involved in numerous ways in the securities markets and which were mainly owned and directed by Dr Garretty and members of his family. These family companies were closely associated with two public companies which engaged in share speculation and with four public mutual funds, each of which had, in turn, a share-trading subsidiary. In mid-1971, ten of the family companies went into voluntary liquidation with deficiencies totalling about $1.2 million (part of which was represented by intra-group debts). At about the same time, two of the mutual funds also went into voluntary liquidation: one fund (Dividend Fund Incorporated) with 163 members had lost shareholders' funds of $483,189 and incurred a further deficiency of $125,281; and the other fund (Increment Fund Incorporated) with 330 members had lost all but $33,576 of its shareholders' funds of $856,000. In addition, after speculating heavily with the use of brokers' credit, the share-trading subsidiaries of these two mutual funds had a combined deficiency of $934,375 (Committee Document 12-1). Dr Garretty and his son, Mr Peter Duhan Garretty, also lost control of the management of the two public companies, Trendex Mineral

Corporation Ltd and Selected Mining Holdings Ltd, in mid-1971, and in the subsequent reckoning it was found that about $2.5 million had been lost by these companies in the preceding period of five months.

Although the Committee obtained information on various aspects of the affairs of these inter-related proprietary and public companies~ most of which were based in Melbourne, we have selected for examination in this Report only a limited number of dealings that took place during late 1970 and early 1971, well after the establishment of the Committee. Over this period, the Garretty family's proprietary companies were facing increasing financial difficulties which culminated in the disastrous collapse we have mentioned. The evidence shows how, in a series of transactions between the two public companies and the family companies, Dr Garretty and Mr P.D. Garretty were involved, on the one hand, as directors, managers and advisers of the two public companies and~ on the other hand, as directors, managers and owners of the family companies. In turn, some of the family companies managed~ and operated for, the two public companies. It will be seen how the resulting conflicts of interest faced by Messrs M.D. and P.D. Garretty were resolved in favour of the family companies at considerable loss to the investing public. The evidence also shows how a private placement of new shares by a public company was made to protect the interests of the company's directors, and it reveals a variety of other abuses in which directors were involved. At no stage during our inquiries into these matters was there any evidence of either the Option Brokers Association or the State government authorities having any regulatory machinery in operation to reveal and prevent the abuses.

The Flotation of Trendex Mineral Corporation Limited

One of the key companies in which Dr Garretty and members of his family were involved was Trendex & Coo Pty Ltd which, as an 'Investment Counsellor', had the functions of publishing and distributing share market newsletters, providing investment advice, and managing share portfolios for members of the public. Towards the end of 1970, Trendex & Co. Pty Ltd promoted a public company called Trendex Mineral Corporation Limited (TMC), and arranged for a prospectus to be prepared and issued for the public sale in Australia and London of a total of two million shares at $1.075 each. The underwriters of the flotation were Corrie & Co., a member of the Brisbane Stock Exchange, and Citron, Williamson, Croft & Co., a member of the London Stock Exchange. TMC's objectives were to invest 'not less than half' the funds in 'listed securities, drawn principally from the minerals sector, with the aim to obtain maximum growth of shareholders' funds on a long-term basis', to trade in shares with not more than one quarter of the funds, and to obtain 'direct participation in mining ventures'. Dr Garretty and Mr P.D. Garretty were directors of TMC, and their family company, Trendex & Co. Pty Ltd was app6inted the manager of the company for a fee of 0.5 per cent a year of the market value of the shares held, as well as an 'incentive' fee amounting to 5 per cent of the capital appreciation each quarter. In addition, Trendex & Co. Pty Ltd was to receive 5 per cent of the annual profit (before tax) derived from the company's mining ventures.

While the TMC prospectus was on the market, share prices generally were falling, and difficulties were experienced in attracting public subscriptions for the London part of the issue. Of the one million shares underwritten by the London broker, Trendex & Co. Pty Ltd had agreed to guarantee subcriptions for 750,000 shares (Committee Document 12-2) and, on 10 December 1970, the London broker asked Trendex & Co. Pty Ltd to meet its commitment (Committee Document 12-3). But Trendex & Co. Pty Ltd declined to do so and, on 18 December, Dr Garretty rescinded the sub-underwriting agreement in a letter to the underwriter on the grounds of 'the acts and omissions' of the London broker (Committee Document 12-2). The Committee has insufficient information to comment on the circumstances leading up to the breakdown of the sub-underwriting arrangement (see Committee Documents 12-2 and 12-4 for the explanations of Citron, Williamson, Croft & Co. and Dr Garretty), but we note that, at the time, it is unlikely that Trendex & Co. Pty Ltd would have been able to subscribe for any significant number of shares from its own resources. In the result, the London underwriter subscribed for 506,000 shares, and the balance of the subscriptions was received from 1,255 subscribers in Australia and overseas, 870 of which held less than 500 shares and 1,120 less than 1,000 shares.

<u>Post-flotation Manoeuvres</u>

In the weak market conditions prevailing in January 1971 it was expected that the TMC shares would be quoted at prices below their cash asset backing of about $1 and, with $2 million as the prize, Dr Garretty was fearful of another company attempting to acquire control of TMC as soon as the shares were listed on 21 January 1971. In fact, the shares sold at prices between 55 cents and 70 cents on the opening day, and a Sydney company, Glomex Mines No Liability, which apparently made a practice of camouflaging its market forays (see Chapter 4), on 22 January appointed a Sydney mutual fund, Australian Mutual Growth Fund, to act on its behalf in attempting to acquire control of TMC through market purchases (Committee Document 12-5). Four days later, on 26 January, Glomex believed it had achieved its objective by buying 1,105,000 shares of the two million TMC shares on issue for a cost of about $1 million. That day a representative of the mutual fund told Dr Garretty in a telephone conversation that the control of TMC was now in new hands and the purchasers wished to have a discussion with him. Dr Garretty said he would talk about the matter after 48 hours had passed.

Before he received this telephone call, however, Dr Garretty had become increasingly concerned about a takeover attempt being made for TMC, and he and the TMC directors had been actively and urgently considering what defensive steps they could take. Their first major step was completed on 26 January, when TMC acquired control of another public company, Selected Mining Holdings Limited (SMH). As is the case with Glomex Mines, the name of Selected Mining Holdings has appeared in a previous chapter (7) of this Report. Between 7 and 18 January, TMC had bought 644,500 shares in SMH for $118,000, and now, on 26 January, a large parcel of 4,152,000 shares was purchased for $788,000. (This holding had been accumulated by a company called Devex Ltd in an attempt to take over SMH). As Dr Garretty expected to have the support of other large shareholders in SMH, the effective control of that company was in the hands of the TMC directors on the night of 26 January. The next day Dr Garretty and Mr P.D. Garretty were appointed to the SMH board, and the previous four directors resigned. Dr Garretty said that the reason for spending such a large amount of TMC's funds in this way was to create a 'larger structure, which would be more complex ... and be therefore more resistant to takeover' (Ev. 2409). He recognised that TMC's acquisition of SMH was an act similar to the one which TMC was trying to avoid in respect of itself, but he also believed that SMH 'had already been taken over and it was a case of: "Who is going to pick up the carcass?"' (Ev. 2409). Dr Garretty was also aware that such a large outlay of TMC's cash in buying shares in SMH was hardly in accordance with the prospectus' objectives, but he believed that this action was justified at a time when TMC 'was fighting for its own life and identity' (Ev. 2406).

A bizarre series of market transactions now commenced, for part of Dr Garretty's plan for creating a more complex structure was to use SMH's funds to purchase TMC shares at the same time as TMC was buying SMH shares (Ev. 2408-09). Moreover, this mutual share buying by the SMH and TMC companies to avoid being taken over by what Dr Garretty described as 'the predator' took place before the TMC directors gained formal control of SMH. On the evening of 26 January it was arranged that SMH would buy a placement of 100,000 new TMC shares at $1 a share, thereby diluting the Sydney bidder's holding in TMC and, at the same time, placing the new shares within the control of the existing TMC directors. A similar attempt was made to place 100,000 new shares with Rimibo Resources Ltd, which Dr Garretty believed was controlled by SMH, but this placement was not completed. On 27 January, the SMH board meeting at which Messrs M.D. and P.D. Garretty were appointed directors took place at 6 p.m. The next board meeting of SMH began at 6.35 p.m. on the same day, with Dr Garretty as chairman and Messrs P.D. Garretty and K.H. Grant as the other directors present. The decision to accept a placement of 100,000 TMC shares was then approved as the first item of business.

The second item of business at the same meeting was to ratify and authorise 'the market purchases of shares in Trendex Mineral Corporation'. To carry out this part of the plan Dr Garretty arranged for large orders for TMC shares to be placed on behalf of SMH with fifteen stockbrokers (Ev. 2419) and, by 5 February, a total of 565,800 shares had been bought for SMH at a cost of $606,722. Some of the shares were bought in the name of Trendex & Co. Pty Ltd (Dr Garretty's family company), and this company also instructed some brokers to 'book' sales of TMC shares from the 'portfolio management clients of Trendex & Co. Pty Ltd' to SMH. Dr Garretty agreed with the Committee's suggestion that in these dealings he was acting in the capacity of 'agent for the seller and agent of the buyer and the adviser of the seller and the adviser of the buyer'. He said, however, that he did not inform his clients of his conflicting positions, and he added that he did not regard himself as having any obligation to do so (E-hr. 24-19-20).

Thus within a day of receiving information of an attempt to take over TMC, Dr Garretty and his fellow directors had spent $788,000 of TMC's funds in buying SMH shares (in addition to the previous purchases costing $118,000) while, on the other hand, after gaining control of SMH, they had committed about $700,000 of SMH's remaining funds of about $1.3 million to buying TMC shares. From the viewpoint of TMC shareholders, the volmne of funds left within their company and available for earning profits had been reduced by about 45 per cent. The shares acquired in exchange for the large outlay of cash amounted to a controlling interest in SMH, but as SMH had spent a major part of its funds in buying TMC shares, its capacity to make profits and pay dividends to TMC had been greatly weakened. It is therefore impossible to see any benefit in the transactions from the viewpoint of TMC shareholders. From the point of view of SMH shareholders, their main asset was now a large minority holding in TMC which, as we have just seen, had had its profit-earning potential greatly reduced by the inter-company share dealing.

Section 17 of the Uniform Companies Acts forbids a subsidiary from buying shares in its parent company, but the TMC directors had been careful to keep their holding in SMH slightly below 50 per cent. The result is a classic case of waste of capital for two groups of public shareholders. Were it not for section 17, a reciprocal process of mutual share buying by two companies, if extended long enough, could result in the first company holding nothing but shares in the second, while the second company has nothing but shares in the first, with neither company having any earning capacity. In the case of the two companies under discussion, the process of dissipation was taken about as far as it legally could be.

Certainly, these interlocking share purchases cannot be judged to have been in the interests of the shareholders of either company. In our view they were part of a desperate attempt by the TMC directors to retain control of the company even though the steps involved meant imposing large and probably irrecoverable losses on the shareholders of both TMC and SMH. In SMH's case in particular, the directors' authorisation of the purchase of TMC shares showed a total disregard of responsibilities to the minority shareholders in SM}{.

Attitudes to the Stock Exchange

Although much of the juggling of TMC's and SMH's funds during the 26 and 27 January must have taken place concurrently, the formal record shows that the directors of TMC were attending a meeting on 27 January from 9.20 a.m. to 1.30 p.m. (Committee Document 12-6). While this meeting was in progress, contact was kept with the stock exchange (Ev. 2415), and during the morning Glomex Mines N.L. announced publicly its purchase of what it believed to be a majority holding of TMC shares. Now the A.A.S.E. List Requirements specifically provide that when the directors of a listed company have had notice of 'an actual or potential takeover scheme' the company is not to allot further shares without the approval of shareholders. Whether or not TMC had had notice of a takeover when it made the placement of shares to SMH may depend on the strict meaning of the phrase 'notice of a takeover' and how the timing of a placement is determined. But in our view there is no doubt that TMC had broken the spirit of the List Requirements. In addition, when TMC announced during the morning of 27 January that it was proposing to offer its own shares for one-third of the shares in yet another company, Longreach Oil

Limited (a deal arranged on the telephone with a broker as another means of diluting Glomex's equity holding in TMC, see Ev. 2413-14) it was acting contrary to the requirements of the stock exchanges.

Dr Garretty said his attention had been drawn to the requirements of the A.A.S.E. Listing Manual by the company's legal adviser, but he had not regarded them as a serious hindrance to the various defensive plans he and his associates had set afoot (Ev. 2414). First, he drew a distinction between a stock exchange requirement and a law, saying there was 'nothing legally against ... any of these moves' (Ev. 2414). Secondly, in his view the stock exchange requirements conflicted with what he took to be the interests of TMC's shareholders, and for this reason he was not inclined to take very seriously the exchange's attempts at regulation (Ev. 2415-16). It will be observed how Dr Garretty regarded the directors' manoeuvres as being in the interests of TMC shareholders. As we have already indicated, this explanation would be more convincing if those shareholders had not lost so heavily as the result of the various transactions, and if the directors had been willing to inform them at the time of all the actions being undertaken on their behalf.

Our inquiries revealed that the Melbourne Stock Exchange executives did attempt on several occasions to find out what was taking place during these convoluted dealings in TMC and SMH shares in order to try to enforce the A.A.S.E. List Requirements, but they were either misled or inadequately assisted in their inquiries. For example, on 28 January, the Exchange asked TMC to answer a number of questions including the extent of SMH's 'beneficial ownership' of TMC (Committee Document 12-7). TMC's reply on 29 January was 4.8 per cent (Committee Document 12-8). But as we now know, by 28 January, Dr Garretty and his directors had decided to use SMH funds for large-scale buying of TMC shares, and on 28 January 448,300 shares had been bought on the market

(Committee Document 12-9). These shares, plus the 100,000 acquired in the placement, meant SMH had bought about 26 per cent of TMC's capital. It scarcely needs saying that if the directors of some public companies are prepared to ignore stock exchange requirements when it suits their interests, and to regard stock exchange inquiries with disdain, there is an obvious need for government action, whether directly through a governmental regulatory body or by way of backup of self-regulation, to ensure that rules and procedures laid down to provide a fair and efficient securities market are observed.

Option Dealing with the Family Companies

Trendex Mineral Corporation (TMC) commenced business on 2 December 1970, and on 9 December it began dealing with Dr Garretty's private company, Stock Options of Australia Pty Ltd. By 22 January 1971, TMC had purchased numerous call options over shares in various major mining companies. In other words, within a stated period (mostly two months) TMC could call upon Stock Options to sell to TMC a specific number of these shares at the prices agreed upon. At the same time as Stock Options entered into these arrangements with TMC, it entered into contracts with other companies (known as 'writers') which agreed to sell to Stock Options, within the stated period, the shares concerned at the prices nominated. TMC paid $145~152 to Stock Options for arranging these options, and most of this sum was passed on to the 'writers' for agreeing to sell their shares if called upon to do so.

As we have already said, Stock Options of Australia was one of the companies which was directed, owned and substantially managed by Dr Garretty and members of his family, and the TMC prospectus had said that business would be done with Stock Options. However, the involvement of the Garretty family's companies in the option dealing went further than this, for with most of the option contracts the 'writers' were also companies owned and directed by Dr Garretty or members of his family. Dr Garretty and Mr P.D. Garretty were therefore involved in an extraordinary range of conflicting roles. They were directors of TMC, the public company, and their family company, Trendex & Co. Pty Ltd, was the manager of TMC. Trendex & Co. Pty Ltd had negotiated the purchase of call options with Stock Options of Australia Pty Ltd, which was also one of the Garretty family's companies, and this company had, in turn, arranged for most of the options to be 'written' by several other Garretty family companies. We have established that these latter companies did not, at the time, hold the shares which they had agreed to sell if called upon to do so; and as they were running into financial problems they would have found it difficult to raise the resources to carry out the necessary purchases. In their capacity as the 'writers' of the options, the fanlily companies had an interest in the shares concerned falling in price, for in this way they would maximise their profits from the transactions, whereas it was in TMC's interest for the share prices to rise in order to derive profits from the call options. In the circumstances it is impossible to see how Dr Garretty and his son could have satisfactorily resolved their conflicting roles or fairly set prices at which options should be arranged. As events turned out, TMC, the public company, lost on most of the transactions and the family companies profited (Committee Document 12-10).

On 25 January 1971, after one of TMC's directors, Sir Horace Petty, had raised the question of common directorships, it was agreed that there would be no further option dealing among companies associated with the directors. Messrs M.D. & P.D. Garretty then turned their attention to Selected Mining Holdings, which came under the effective control of TMC on 26 January. The two directors of TMC who were appointed to the SMH board were Dr Garretty and his son and, within a week, the new SMH board of

Dr Garretty, Mr P.D. Garretty and Mr K.H. Grant had appointed an investment committee of which the members were Dr Garretty and Mr P.D. Garretty. The option dealing, which had been stopped by the dissent of some TMC directors, then proceeded to take place through TMC's week-old associate.

SMH's investment committee was appointed on 4 February 1971 and, beginning on 5 February and concluding on 15 February, in 27 different transactions, SMH acquired call options from Stock Options for the following shares: 10,000 BHP, 2,000 Poseidon, 2,000 Queensland Mines, 20,000 Western Mining, 18,000 Kathleen Investments, 20,000 Utah Mining, 20,000 Metals Exploration and 10,000 Conzinc Rio Tinto. As we have already discussed, the new SMH board had already used a large part of that company's shareholders' funds to buy TMC shares, so at the same time as the option dealing was undertaken shares were sold from the trading portfolio to provide some of the necessary finance (Ev. 2444). The 'writers' of the options were in most instances, companies directed, owned and managed by the Garretty family, and these companies neither held the shares they had agreed to supply (if called upon to do so), nor had they the resources to buy the shares. In most of the transactions SMH lost funds and, once again, if the SMH shareholders had known of the circumstances in which these dealings were taking place it is difficult to see how they could have been satisfied that their interests were not being systematically sacrificed in the interests of their directors' family companies.

According to Dr Garretty, the balance of the call options sold by Stock Options to TMC and SMH were 'written' with one or more mutual funds or their share-trading subsidiaries (Ev. 2403 and 2444-45). However, these dealings could no more be regarded as having taken place at arm's-length than those involving the family companies. For in each case the mutual fund and its share-trading subsidiary was managed by a company called

Fund Custodians Pty Ltd, which was another of the family's companies, and this management company in turn was advised by Trendex & Coo Pty Ltd which, as we have just seen, was the member of the family group advising TMC on its option dealings.

The amount paid by SMH to Stock Options for negotiating the call options we have mentioned was about $125,000, but this was later followed by the payment of a further sum of $158,909 when SMH exercised its options to buy 5,000 BHP shares and 8,000 shares in Kathleen Investments between 16 March and 14 April 1971. At about the time of these payments TMC also paid a sum of $89,576 to Stock Options in order to exercise options to acquire certain shares. In both cases, however, Stock Options failed to deliver the shares to the public companies in exchange for the money. The financial position of the family companies had worsened since January, and Dr Garretty told us that the funds paid over by TMC and SMH to Stock Options had been used in settling some of the debts of the other family companies (Ev. 2446-47). A further $15,750 owing to TMC from option dealing also appears to have been used in this way. In summary, while acting on the advice of Dr Garretty and Mr P.D. Garretty in their option dealings, the two public companies, in a period of a few months, lost the greater part of the total payments of about $500,000 which they had made mostly to the Garretty family companies.

Dr Garretty informed the Committee that from the time TMC's business began, it had been his intention as manager (through Trendex & Co. Pty Ltd) to engage in option dealing through Stock Options and to have the options underwritten by his companies (Ev. 2404). He said that he had been advised that it was not necessary to disclose in TMC's prospectus that the family companies of two of the directors would be underwriting the options (Ev. 2599 and 2405-4). In his experience 'the option market had dwindled to almost zero' in late 1970 and he had found option 'writers' apart from his own companies 'practically unobtainable' (Ev. 2404). Dr Garretty's explanation of why TMC and SMH had not received their shares after paying for them was simply that 'the group collapsed' and 'the writers of the options became insolvent' (Ev. 2403); and he added that the reason the money had not been kept in a trust account was: 'because there was no provision for trust accounts in this business' (Ev. 2448). He said that 'up to the end of May [1971]' he did not believe the money would be lost (Ev. 2454).

According to Dr Garretty, several factors had led to 'liquidity difficulties' and then a 'crisis' for his family's group of companies, one of which was the loss incurred on the flotation of TMC (Ev. 2446 and 2452). In an attempt to overcome this problem, he had begun negotiations with SMH in January 1971 (before TMC acquired control) to sell ten per cent of the equity of Stock Options of Australia Pty Ltd to SMH and to obtain assistance from SMH by way of a loan. Subsequently, when his family group's financial problems had worsened, he had endeavoured to sell 50 per cent and later 100 per cent of Stock Options to SMH and TMC (Ev. 2446-47). For the purpose of selling part of Stock Options, a special document was prepared and presented to the directors of SMH. It presented the activities of Stock Options in a highly favourable light. The projections of future revenue were based in part on the recent figures which, of course, included the dealings of TMC and SMH, and reference was not made to the company's financial difficulties arising from the activities of other members of the Garretty group (Committee Documents 12-11 & 12-12). However, in Dr Garretty's words: 'Negotiations finally broke down on 27 May when it appeared that we were unable to sell the company. At that stage it became evident that the group could not continue' (Ev. 2447). According to the minutes of the directors' meetings of SMH and TMC, it was not until 27 May that there was any reference to the difficulties facing Stock Options and its inability either to supply the shares which had been bought by the public companies or to return their money (Committee Documents 12-13, 12-14 & 12-15).

A Secret Sale to a Family Company

When the directors of Trendex Mineral Corporation gained control of Selected Mining Holdings in January 1971, they also expected to acquire control of Rimibo Resources Ltd, a company owned as to 40 per cent by SMH and having a large holding of cash. To supplement this 40 per cent shareholding, both TMC and Stock Options bought Rimibo shares in the market and, in February 1971, attempts were made to persuade the Rimibo directors to resign in fayour of directors nominated by SMH (Committee Document 12-16). However, the Rimibo directors refused to co-operate in bringing about these changes, one of their reasons being that Glomex Mines N.L. had announced it held a controlling interest in TMC and until the legal proceedings affecting this takeover attempt were resolved it would not be known who had control of TMC, SMH and Rimibo. This attitude of the Rimibo directors led to Dr Garretty and the other SMH directors attempting various other devices to obtain control of the Rimibo company.

One of their first steps was to sell SMH's entire holding of 1.2 million Rimibo shares and 600,000 options to a company called Underwriters Pty Ltd on 13 April 1971 for a sum of $340,000 payable by means of a deposit of $34,000, five instalments of $50,000 in October and April of each year, and a balance of $56,000 in April 1974. Under this agreement Underwriters Pty Ltd could sell the shares and options on whatever terms it decided provided it accounted to SMH for any profits made within four years from these sales. The agreement also gave the purchaser the right to terminate the arrangement within three months and to receive back the deposit less interest. In his evidence Dr Garretty said that Underwriters Pty Ltd was another company directed and owned by himself and his family and the effect of the agreement was to give this company the right to exercise the votes representing 40 per cent of Rimibo's share capital (Ev. 2459). The reason for the sale, according to Dr Garretty, was to prevent Rimibo falling into the hands of Glomex Mines N.L. if that company were successful in obtaining control of TMC and SMH (Ev. 2456). In addition, Dr Garretty was apparently not excluding the possibility of legal action being taken by Glomex to prevent TMC and SMH gaining control of Rimibo (see his letter to the Committee 27 June 1972, Committee Document 12-17). However, when the SMH directors minuted their decision to arrange the sale of Rimibo shares and options, it seems they were motivated by other considerations, and that it was the expected removal of the threat of a takeover by Glomex which had cleared the way for the sale. The minute reads:

Internal divisions and financial difficulties beset Glomex Mines and its shareholders (which as previously expected should lead to the elimination of the danger to the interests of this company which was posed by the bid for control).

Therefore an opportunity exists to continue with the aims of the group, amongst which is the reduction of the burden of an individual company of holding a greater proportion of its capital in the form of shares in another member company in the group.

(Committee Document 12-18)

We are therefore left in some doubt about the specific purpose of this sale, and in his evidence Dr Garretty also seemed less than sure as to what had been envisaged. He said the purchase 'was not a profit making undertaking on the part of Underwriters Proprietary', and added that the company 'was, in effect, a nominee for some purchaser to be found in the future' (Ev. 2456).

Whatever the objective of the transaction, however, the Committee was concerned that the directors of the public company, SMH, had sold, largely on credit, between about 20 per cent and 25 per cent of the company's assets to a proprietary company owned by two of the directors without informing shareholders and obtaining their approval to the transaction. Our concern increased when we learned from Dr Garretty that, at the time of the transaction, the purchasing company, Underwriters Pty Ltd, had been experiencing liquidity problems and the company's assets were 'very little' (Ev. 2454). In answer to our inquiry as to why he had not announced the sale Dr Garretty said: 'I saw no cause for it' (Ev. 2454). It was pointed out to Dr Garretty that the A.A.S.E. List Requirements specifically require listed companies to notify the exchange 'immediately of any significant sale of shares in another company', but he was unable to recall whether this matter had been considered by the SMH directors (Ev. 2461-62). Once again, in explaining his attitude, Dr Garretty implied that he had been interested in what was the law, not in the stock exchange requirements. 'First of all' he said, 'consider the legal obligation: I consider there was no legal obligation to inform shareholders' (Ev. 2455).

Although SMH had sold the Rimibo shares in April 1971, the SMH directors continued to act as though SMH still owned the holding, thereby illustrating yet again the close inter-relationship between the affairs of the Garretty family companies and the public company and the difficulty of knowing in whose interest particular transactions were being negotiated. Together with TMC's directors, the SMH board, in May 1971, proceeded to take steps to call an extraordinary general meeting of Rimibo shareholders in order to remove the present directors of that company and have Dr Garretty and his associates appointed in their place. As more than 50 per cent of Rimibo's share capital was held by

SMH, TMC and Stock Options, it was expected that the control of Rimibo would pass to the Garretty group. It was recognised at the time by Dr Garretty that a possible hitch in the completion of this plan was that the Rimibo directors could obtain an adjournment of the meeting by having the appropriate motion passed on a show of hands as soon as the meeting had begun, and to forestall such a possibility the SMH directors had engaged a firm of public relations consultants 'to organise ... the public vote' (Ev. 2459). In addition, over 100 university students were recruited to attend the meeting with SMH proxies and to vote according to SMH's instructions, and for this service they were paid $1,250 by SMH (Ev. 2460). At the meeting on 14 May 1971, following much publicity, and in the presence of a television camera, the Garretty group was successful in removing the previous Rimibo board.

However, the Rimibo directors had themselves been active in preparing for the meeting and one of the directors, Mr Richard Owen Parsons, who had also been the company's underwriting broker, told the Committee of his experience of the events leading up to 14 May 1971. Part of the transcript reads as follows:

Mr Parsons: ... We, of course, as a board discovered what was going on in the way of all these university students being given proxies. All my clients who had taken shares in this company were being rung up at all times of day and night and literally badgered into giving their proxies to unknown persons. They were ringing me asking what were they to do ...

Senator Rae: ... Did they indicate to you who was telephoning them?

Mr Parsons: They stated that Dr Garretty's office was telephoning them.

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Senator Rae: Would you be able to indicate to us whether you have any knowledge at all why Dr Garretty, or his son or people associated with either of them were endeavouring to obtain these proxies ...

Mr Parsons: ... the idea was to pack the meeting to such an extent that we could be out-voted on a show of hands for an adjournment ... But of course at no stage did we ever consider an adjournment. We had our own thoughts on what we would do about this matter. I had a telephone conversation with a person who would not give his name but described himself as 'a dissatisfied member of the Garretty camp', who warned me at least ten days before this meeting of the fact that Garretty's empire was about to fall, that they were desperate for money and, knowing that Rimibo had large sums of money at their disposal, were determined by fair means or foul to remove the board, put themselves into control and run the company, thereby having quite a large cash element available to them. This was told to me about ten days before. On receipt of this, I warned the board of what was afoot, what I had heard and what had been said to me, and we made arrangements which are now a matter of public knowledge to defeat this move .o.

(Ev. 2436-37)

At 8.30 the night before this meeting of 14 May the Rimibo directors met and appointed three new directors (one of whom became chairman) who could not be voted out of office the next day; to bring about their removal another meeting would have had to be called. Thus, when the three new SMH representatives joined the Rimibo board they found that they were not in a position to control the company. Within the next two weeks Underwriters Pty Ltd terminated the agreement to buy the Rimibo shares and options from SMH, and there was a general collapse of the Garretty family companies followed by the resignations of Dr Garretty and Mr P.D. Garretty from the boards of TMC, SMH and Rimibo.

When the accounts for the financial year to 50 June 1971 were subsequently published, the enormity of the total loss arising from the market 'raids', interlocking transactions and incestuous dealings was revealed to shareholders. Trendex Mineral Corporation, which had raised about $2.1 million in December 1970, had lost about $1.5 million in the first six months of its life. Selected Mining Holdings, which had held about $1.5 million in assets when TMC gained control in January 1971, had lost approximately $1 million in the five months to June 1971; and Glomex Mines had lost about $450,000 over the same period on its holding of shares in Trendex Mineral Corporation bought in January 1971. Of the $5.4 million that had been available to the directors of TMC and SMH, over 65 per cent had been lost within a few months in reckless share and option dealing which, in our view, had been largely motivated by the directors' desire to protect and benefit their own personal interests. In these instances the role of the stock exchange had been reduced to that of a public forum for speculative waste; a mockery had been made of its function of floating companies for the purpose of carrying out economic development.

Where were the Regulators?

The growth of the group of companies associated with members of the Garretty family, sometimes referred to as the Trendex group, took place mainly during the 1960s and in 1970, and it was during this period that Stock Options of Australia Pty Ltd, the option broker, Trendex & Co. Pty Ltd, the investment consultants, and the share-trading and option 'underwriting' companies integrated their respective activities. Although there were several companies which specialised in share-trading and option 'writing', other members of the group also engaged in these activities, including Trendex & Co. Pty Ltd and Fund Custodians Pty Ltd, and Dr Garretty himself ran share-trading accounts. Another member of the Trendex group during part of the 1960s was Second Market Pty Ltd, a company set up to engage in stockbroking in competition with the Melbourne Stock Exchange.

At one stage it was intended to establish this company in Perth where it would have competed with the Perth Stock Exchange, but this plan was not completed. While most of the Trendex group's activities involved dealings in shares listed on one or more of the Australian stock exchanges, some business was done in mining titles and in wool futures, and one of the companies in the group, Commodity Futures Pty Ltd, was an associate member of the Sydney Greasy Wool Futures Exchange.

Dr Garretty confirmed that there was a significant volume of securities business done between different members of the Trendex group (Ev. 2595), and we have seen how these dealings also extended to and embraced the two associated public companies. Investigations by the Committee also revealed that substantial business was done among the various mutual funds, and extensive dealings also took place between mutual funds, and the family companies. Dr Garretty said the share-trading subsidiaries of the mutual funds had 'used' options 'for many years' (Ev. 2404). At the time of the collapse of the mutual funds, large amounts were owing to them by their management company, Fund Custodians Pty Ltd, which was owned by the Garretty family. In other ways, too, a web of financial associations integrated the group. Dr Garretty said, for instance, that the option broker, Stock Options of Australia, acted as 'banker' for the family group (Ev. 2446 and 2452) and, in his evidence before the Registrar-in-Bankruptcy in February 1972, he explained how he had become indebted to the family companies. When asked how this came about, he said:

By a process of myself and these companies acting as banker for each other, the ebb and flow of financial turmoil. There had been times when Stock Options of Australia was $50,000 to $60,000 in debt to me, when it was passing through a lean period, and the course of the pendulum was just that it just worked that way.

In the case of Second Market Pty Ltd, the company set up to run a stockbroking business, the interweaving of associations was complicated further as the result of the public mutual funds becoming substantial shareholders in Second Market. The shareholders of the mutual funds were not told about this holding which was registered in the name of a nominee. Commodity Futures Pty Ltd was another member of the group in which the mutual funds were shareholders.

Although the Trendex group operated primarily in Melbourne, it spread its activities widely throughout Australia and to London. For instance, the option broking company had, at one time, extended its operations to Sydney, Brisbane and Canberra, and it had planned a joint operation in Adelaide with another option company and a group of brokers. At no stage, however, were any of the activities of the companies in the Trendex group, excluding the two public companies Trendex Mineral Corporation and Selected Mining Holdings, within the jurisdiction of the stock exchanges so that, for example, there was no action which the Melbourne Stock Exchange could have taken to regulate directly the business practices of Stock Options of Australia Pty Ltd. This company, which acted as 'banker' to the group, was a member of the Option Brokers Association, but that body was not equipped to carry out any effective regulation, and it proved incapable of preventing the practices that we have described. Thus if there were to have been any effective regulation of the affairs of the Trendex group during the 196Os, it would have had to have been by another authority. The Committee therefore asked Dr Garretty about his experience of State government regulation.

Dr Garretty said he did not recall any regulation applying to option dealing during the 1960s; in addition he had found that there was no specific legislation covering his stock-broking company. In a discussion with the Victorian parliamentary draftsman he had been told that the Second Market 'was not a broking house' and was not covered by the legislation applying to stockbrokers (Ev. 2394). In Dr Garretty's experience, up until 1970, when the Securities Industry Act was introduced, there had not been any specific restrictions or limitations by way of legislation or regulation covering his companies' activities in circulating investment newsletters, underwriting options, managing mutual funds and in conducting business between the various members of the Trendex group. In discussing events since the passing of the Securities Industry Act, he said that an investigation had been made of some of the affairs of the family companies, including the option dealings discussed in this chapter, but that these took place after the collapse, and he had not been interviewed until about another year had passed. He could recall no inquiries being made about the share placement, the takeover of Selected Mining Holdings and the interlocking share dealings.

In this chapter we have been discussing a limited segment of the activities of a group whose conceptions of what is right and proper conduct were found, on each occasion of our bringing them under investigation, to boil down to what they considered was not explicitly forbidden by the letter of the law - the enforceable law of the land, with little regard for such standards or conventions as any non-statutory body might prescribe. It is a group, moreover, which has operated largely in sections of the securities markets, such as the promotion and management of mutual funds, where there was not a tradition of an internal code or a structural organisation attempting to impose standards of professional conduct. In another of these new fields, options dealing, having itself founded a professional association the group proceeded to break its implied standards. The leading spirit of the group has shown a ready agility for devising new methods and formulas for slipping away from the constraints of the letter of the law when they do appear to inhibit his freedom of action. He is a man who, under examination, showed himself to be undeterred by the possibility of incurring moral censure or by a consideration of his own disastrous record in handling great sums of the public's money.

It would not be difficult to heighten the note of farce in a full account of Dr Garretty's activities: the shufflings of money so freely and without scruple from one listed company under his control to another or into buying shares in a company where his control was under challenge; the stacking of company general meetings with university students, and to no avail; the repeated failure of the inventor of so many devices to achieve or construct anything permanent as a result of his busy strategems. His inability to survive as the master of the financial complex he built has led to this much exposure. Had he merely managed to keep the complex financially solvent, the abuses and misdirection of public money might have continued on a big scale without being observed. The record of this group provides illumination on what a similar lack of scruple combined with greater skill might do (we have made the same comment in other sections of this Report), and from the Committee's viewpoint this is the practical relevance of the bizarre aspects of Dr Garretty's record. The losses which his complex brought on various members of the investing public in the short period covered by events mentioned in this chapter were more than $4,000,000. The especially grievous character of the mutual fund losses of about $ 1.4 million is, first, that investors in the funds were probably relatively security-minded and inexpert people who are least able to afford such setbacks, and secondly that they were to be shocked to discover that their personal liability was not limited to the amounts they had subscribed to the funds. The prospectuses of the two funds had given investors no clear indication of their potential liability.

Dr Garretty has been another example of a person filling a multiplicity of roles in the securities markets. As well as manipulating options deals and company structures, he was an investment counsellor and a controller of mutual funds. In this chapter, we have confined our narrative mainly to the first two functions, since the purpose of our reporting is to illustrate as wide a range of practices as possible, and the conditions of supervision which have existed over this range. The role of investment advisers has already been the subject of a chapter in this Report, but the evidence of this chapter is an additional reason why such advisers should not be permitted to operate without close supervision. The scope for improper handling of mutual funds when control rests with persons having corporate interests is illustrated in the chapter concerned with Mineral Securities Australia Ltd, which was a bigger group than Dr Garretty's; but again, the activities of the Trendex group are evidence of the, need for more effective regulation in this field.

Within the limited field of options dealing, we have seen how Dr Garretty set up a structure of inherent conflicts which were irreconcilable so far as the interests of all the parties were to be considered. Dr Garretty had been operating in this area for many years before his insolvency. Not until about ten years had gone by, did the State government regulatory authority attach any significance to the growth of an options market and the organisational and institutional changes that accompanied that development; and even after legislation had been passed, it took a delayed reaction to a widespread collapse to bring about any inquiry into problems that had been building up for many years. Legislation of a general kind which could give State government inspectors the right to investigate options dealers was proclaimed on 1 June 1970 during the peak of Dr Garretty's activities, but even now the Act does not spell out any requirements which would restrict conflicting interests and incestuous associations.

With persons of such agility as we have described it is not enough to have a general Act on the statute books. Option dealing should be subject to rules and conditions which restrict conflicts of responsibility and which otherwise prescribe standards for conducting these businesses. The case we have examined shows that the enforcement of standards cannot be left simply to professional groups such as the Option Brokers Association. Whilst self-regulatory bodies have an important role to play, a statutory body must have the final responsibility for setting minimum standards and ensuring that they are maintained.

CHAPTER 14
MINSEC

No company in Australia has had a more spectacular rise and fall than Mineral Securities Australia Ltd. Formed in 1965 as an unlisted company with an initial paid capital of $170,500, and listed on the stock exchanges in 1967 after a comparatively small public issue of $137,500, the company had acquired assets in excess of $100 million by the end of 1970. The market valuation of its issued capital was then about $70 million. Five weeks later, the shares were suddenly suspended from trading on the exchanges, preliminary to their formal removal from the lists forever as being worthless.

At its peak in the latter months of 1970, Mineral Securities controlled the production of more than 20 per cent of the world's futile, and was, through a subsidiary, the second largest producer of tin and wolfram in Australia. It controlled the company which held the largest share in the Robe River project, and that project rested on the biggest iron-ore contract ever signed. To join them on the board of Robe River Ltd, the directors of Mineral Securities had successfully invited eminent representatives of two of the country's oldest companies, Burns Philp and Co. Ltd and Elder Smith and Co. Ltd. By that time, the Mineral Securities group had also spent about $30 million in acquiring interests in what was believed to be the largest uranium deposit in the world. It had many ventures from a gold mine to cattle lands, but its exalted rating on the stock exchanges rested mainly on its share speculations, in which activity it was evidently the most vigorous practitioner in Australia's history. While its share market status permitted Mineral Securities Australia Ltd to make a number of easy acquisitions of dominant interests in mining companies which were established and going concerns, the acquisitions in turn enhanced the market status of Mineral Securities, since they were taken to be underpinning the company's long-range profitability and to be indicative of a diminishing emphasis on share trading as the major source of revenue. It will be seen later in this chapter that the latter impression was based on inadequate knowledge of the role that subsidiary companies were intended to play in Mineral Securities' share-trading policies. Events were to confute another, much wider expectation that grew out of the rapid expansion of Mineral Securities, namely that it was methodically and in a professional manner promoting the cause of Australian ownership of the country's developing mineral resources during the period when overseas capital had been predominant in that development. Mineral Securities quickly became a nationalist symbol in a sphere where one was wanted. This partly accounted for the widespread good will and confidence it enjoyed. In fact, none of the going mining concerns in which it acquired major interests had previously been in overseas hands, but in the process of liquidating Mineral Securities after its sudden collapse the greater number of these holdings in established mining companies passed into foreign hands. The net result of the company's brief history was to extend the grip of overseas ownership over Australian mineral resources.

Each of the above aspects of the history of Mineral Securities is of national significance, but in addition the failure of the company produced a series of financial consequences which are without precedent in the history of Australian business corporations and the securities markets. While the direct writing off or writing down of the stock exchange capitalisations of Mineral Securities and the publicly held portions of the shares of its subsidiaries and associated companies amounted to more than $100 million, Mineral Securities had also in its latter days become the biggest borrower of a non-institutional character in the short-term money markets.

It drew more than $50 million from these markets in a period of four months. The repercussions from the sudden insolvency of such a heavily indebted company upon the money markets and certain of its large creditors, who were mostly associated with broking firms, appeared to be so dangerous that the Prime Minister convened a special meeting of prominent financiers to. consider courses of protective action. Subsequently, a consortium of financial institutions and other companies came forward with a public offer to make bridging finance of as much as $35 million available in order to help ensure an orderly liquidation of the assets of the Mineral Securities group. The liquidator of the company, who did not call upon this facility, has since said that the announcement of the offer played an appreciable part in stabilising conditions in the money markets and averting the risks of a 'domino effect' from the company's failure. Again, the collapse of Mineral Securities brought immediate severe losses to two mutual funds which the company had launched barely a year before, involving thousands of small members of the public in loss and long delays before their investments of reduced value could be negotiable again. The chain of events in the relationship between Mineral Securities and the mutual funds right through to the company's last-minute withdrawal of millions of dollars from the funds, to the detriment of the interests of public investors in them, underlines a number of important questions regarding the conduct of such forms of collective investment which have been forced on our notice in other hearings during this inquiry.

Early in our investigations, and well before the company's collapse in February 1971, the Committee had obtained preliminary information relating to the activities of the Mineral Securities group with a view to taking further evidence on the matter. The circumstances and consequences of the company's failure served, on the one hand, to provide further indications of the inescapable bearing that the affairs of Mineral Securities had for the nature of our inquiry; on the other hand, these developments have required us to take cognisance of the existence of a concurrent investigation into the company's affairs by investigators appointed by the Government of New South Wales shortly after the suspension of trading in the company's shares. The New South Wales authorities subpoenaed the documentary records of Mineral Securities, and for more than two years, a large body of the company's records was not available to this Committee or to witnesses appearing before us. Upon consideration, the Committee decided that this circumstance should not entirely divert its investigations from the aspects of Mineral Securities' history which are of central relevance to our investigation. It would be impossible to offer a reasonably pertinent report on events and conditions in the securities markets during the period of our inquiry without referring to this extremely influential trader in the markets and the strategies it employed as a corporate group. Such a constraint would deprive our report of realism. There can be no absolute separation of the consideration of operations in the securities markets from internal corporate affairs, and least of all in a group such as Mineral Securities, for in this case share trading and speculation were the dominant activities, several companies in the group were deployed in the trading operations, the group's financing needs and methods, and its attitudes to capital gearing requirements, were largely determined by the share dealing policies, and the multiple roles filled by some directors were related to the same activities. It is a matter of world wide observation, apart from the affairs of this group, that questions of companies legislation and administration join at numerous points with the conduct of the securities markets. Nevertheless, while not attempting to observe rigid demarcations, we have addressed ourselves in this chapter to issues relating to the capital and securities exchange processes. Our primary concern is not with the particular parties in this group, but with general principles raised by a consideration of its operations. Our greatest sense of deprivation in preparing this chapter arises from the fact that complete daily records of the heaviest share trader in Australia's history were not available for the kind of analysis which we have been able to draw upon elsewhere in this Report in regard to firms and companies whose market significance was usually much smaller than that of Mineral Securities. We have, however, been able to obtain important evidence, the nature of which will be seen in the following pages.

The Construction of a Non-Physical Presence

Mineral Securities Australia Ltd (often referred to as 'MSAL' internally, and as 'Minsec' by members of the outside public), was formed as a share-trading and investment company. It had a small share capital in relation to the early scale of its stock market activities. Relations with share brokers were a significant factor in its genesis, for the initial Australian response to its invitation for share subscriptions was tepid and, but for the support of a number of brokers, perhaps dauntingly so. By September 1965, about six months after its formation, and while it was still unlisted, the subscribed capital amounted to some $202,000, of which 60 per cent had been raised overseas (mainly in Canada), and Sydney and Melbourne stockbrokers contributed nearly one-third of the remainder. Mineral Securities began simply as a legal entity, a name upon a door without a distinct physical existence, and so it remained throughout its years of increasingly imposing presence in the mining share markets. It had 'no staff whatsoever, not even typists' (Ev. 1204), and no full-time directors. Daily trading operations were conducted by the company's sponsors, Kenneth McMahon and Partners Pty Ltd, who acted as general managers to Mineral Securities on a fee basis. Meanwhile, the secretarial and accounting work for Mineral Securities was done in the office of A.H. Dickins and

Co., chartered accountants, as also was the secretarial and bookkeeping work for Kenneth McMahon and Partners. This accountancy firm's offices were located in the same George Street, Sydney, building as those of Kenneth McMahon and Partners. Mr D.A.T. Dickins, the senior partner of A.H. Dickins and Co., was the secretary of Kenneth McMahon and Partners and also acted as the share registrar for Mineral Securities. One of his partners in A.H. Dickins and Co., Mr Richard Swift, became the secretary of Mineral Securities and a director of that company.

Mineral Securities thus began as a share-trading adjunct to Kenneth McMahon and Partners, who were mining consultants and advisers, having originally several broking firms among their clients, though the performance of business for brokers on a fee basis ceased after Mineral Securities was formed (Ev. 1214). Mineral Securities was soon to become the biggest component of an increasingly complex group with many adjuncts of its own in subsidiary companies and mutual funds, but its essential character as a managerial adjunct of Kenneth McMahon and Partners, drawing life and initiatives from that private company, did not change.

Mr Kenneth Harold McMahon had been a geologist and mining engineer of more than ten years' experience working in various capacities with Australian and North American mining companies when he joined in the formation of the mining consultancy business of Kenneth McMahon and Partners Pty Ltd in Sydney early in 1962. The original funds of $10,000 were provided from bank overdraft accommodation obtained by his two partners, Messrs Kenneth W. Craig and Reginald Hare, who had considerable mining interests. Messrs Craig and Hare were sleeping partners, each holding a 40 per cent interest at the beginning while Mr McMahon had 20 per cent. Mr McMahon soon afterwards increased his share and later bought out entirely the interests of the other partners. The total price paid for the extension from a one-fifth holding to full ownership was evidently $28,332, and these shares were transferred to the name of Mr McMahon's family company, Macmine Pty Ltd. Kenneth McMahon and Partners was no longer a partnership. Mr McMahon was its chairman, managing director and sole proprietor. He co-opted nine senior employess to a profit-sharing status in the company in an arrangement whereby two-thirds of the distributed profits were allotted equally amongst the 10 executives (including himself), while the other third was left for his family company. The profits that were shared included dividends from Mineral Securities as well as consulting and management fees received from it and other sources (Ev. 1190).

The most significant of the senior staff appointments was that of Mr Thomas Alexander Nestel, a mining engineer with a background of eight years' experience in Broken Hill and an interest in the mining share market. When Mr Nestel joined Kenneth McMahon and Partners in January 1964 he helped to establish that company's 'Investment Consulting Department' (Ev. 1309). In the following year he was appointed a director and investment department manager of Kenneth McMahon and Partners, and he played a prominent part in the formation of Mineral Securities Australia Ltd of which he became the managing director. Mr McMahon was chairman of this new company. Its board included two chartered accountants. One of these was Mr Richard Swift, who, as already noted, also filled the role of the secretary to Mineral Securities. The other accountant, Mr Eric Dubois Spooner, joined the board of Mineral Securities early in 1969; about two years previously, Mr Spooner had given up practising as a chartered accountant and became a senior executive and a director of the Sydney company, A.J. Chown Holdings Ltd. Two further appointments brought the membership of the Mineral Securities board to six by 1970. One of these was Mr M.B. Moorfield, a mining man who was managing director of Aberfoyle Ltd and other public companies in the Aberfoyle group when these became subsidiaries of Mineral

Securities. The last board appointment, that of Mr J.B. Alexander, who was a partner in the prominent London merchant bank of Hill Samuel and Co. Ltd and a resident of the United Kingdom, was taken as notable evidence of international recognition for Mineral Securities. The board could be seen to consist of experts who collectively brought a wide range of experience and training in financial and mining affairs.

The most continuous directorial attention to Mineral Securities, and all of its executive management, came from Kenneth McMahon and Partners, and in day-to-day decisions the management came essentially from Mr Nestel's 'Investment and Trading' department. That department consisted of about ten persons in addition to Mr Nestel. Eight of them were engaged in 'trading' and 'research' divisional functions related to the mining share market while one or two were employed in the 'money market' division of the same department. In the annual accounts of Mineral Securities, the 'Directors' Report' was signed by Mr McMahon, while the 'General Manager's Review of Operations' appeared over the signature, 'Kenneth McMahon and Partners Pty Ltd'. Early in his evidence to the Committee, Mr McMahon supplied a statement of particulars of companies in his group, in which the formal system of communication between his private firm and Mineral Securities was described in this way:

Responsibilities

The role of McMahon and Partners as General Managers of Mineral Securities was as follows:

All contact with the Board in normal course of events was channelled through the Investment Department and specifically through its head who was also formally Managing Director of Mineral Securities.

Other Department Heads appeared at Board meetings rarely and only when specifically called for.

The process of introducing subsidiary or satellite companies to Mineral Securities, these again being usually under the management of Kenneth McMahon and Partners, begun in the latter months of 1965 with the formation of Minsec Investments Pty Ltd as a wholly owned subsidiary having the objective of building a long-term investment portfolio and not coming under the classification of a share trader (Ev. 1190).

Again, in December 1967 Mineral Securities floated a new, listed but subsidiary company named Petroleum Securities Australia Ltd to trade and invest in shares of companies engaged in petroleum exploration and allied activities. Mineral Securities took 51 per cent of the original paid capital of $750,000, made up of 1.5 million shares of 50 cents each, and this proportion was maintained when the capital was subsequently increased in stages to $1,553,658. This was the beginning of a new family branch of oil companies, engendered in a period of market boom for oil stocks. As the next stage, Petroleum Securities, emulating its own parent, formed a wholly owned subsidiary called Petsec Investments Pty Ltd to hold longer term oil investments, as distinct from the share-trading function of Petroleum Securities. It is convenient to mention next, as a third arrival in the oil branch of the family, Petroleum Securities' purchase in September 1968 of a controlling interest in a listed company, Oil Investments Ltd, because after the purchase of an approximate 50 per cent holding (later increased to 58 per cent) in that Adelaide-based investor and dealer in oil and other mineral stocks, Oil Investments became another vehicle for active speculation in tandem with the market dealings of its parent, Petroleum Securities, and grandparent, Mineral Securities. Kenneth McMahon and Partners were promptly appointed as general managers of Oil Investments, as they were of the other two trading vehicles. The portfolio of listed shares previously held by

Oil Investments was sold, and the proceeds used mainly for market trading purposes. Oil Investments continued to be listed on the Sydney and Adelaide exchanges.

The 'Minsec group' had now marshalled its three recognised principal share-trading units (for the sake of completeness a fourth professed trader, the small subsidiary known as Norausam Pty Ltd may be mentioned), though other companies also were to be enlisted in the cause. Meanwhile, the group had not only invested substantially in shares of various mineral companies which were outside its control, but had also floated a new listed oil exploration company, Pexa Oil N.L., in June 1968. The pattern of ownership in Pexa Oil was of a kind that is to be found recurring in the expansion of the Mineral Securities empire and was said to be favoured for taxation reasons. That is to say, while Pexa was not technically a subsidiary of any single company in the group, the ownership of a majority interest was distributed among three (the usual number) members of the group, so that the ultimate control rested with Mr McMahon and his colleagues. Of Pexa's capital of $2,175,957 at the end of 1968, later raised to $7.5 million, 17.7 per cent was held by Mineral Securities, 29.4 per cent by Petroleum Securities and 5 per cent by another member of the group, Amad N.L., which has not previously been mentioned. Amad, a mineral exploration company which was formed in 1955, had been inducted into membership of the Minsec group as early as October 1965. After the success of the offer to buy 50 per cent of Amad's shares at that time, Mineral Securities had appointed three directors to the board, and Kenneth McMahon and Partners Pty Ltd were made the general managers of Amad. The process of general management was to take Amad in some new directions: though Amad had widespread mineral prospecting interests and was not formally regarded as one of the share-trading companies in the group, most of its profits and eventual losses while a member of the Minsec family came from share dealings.

In fact, both A mad and Pexa Oil, though ostensibly mineral prospectors of moderate financial means occupied in physical activity 'in the ground', were to suffer heavy losses~ each running to more than a million dollars, from involvement in the speculative side of the Minsec group's activities or money lent to Mineral Securities in the latter stages of their association with the group. The extent of their involvement was not known at the time or publicised subsequently; the Committee has obtained the information in correspondence with the new directorates of Pexa and Amad which took over the running of the companies after the collapse of Mineral Securities. (Committee Documents 14-1, 14-2).

By way of contrast, in the case of the latest and biggest acquisitions of operational mining interests by Mineral Securities, which require mention, namely the acquisitions of the Aberfoyle group of tin, wolfram, copper, gold and general exploration companies, and of the Cudgen group of beach mining companies, Kenneth McMahon and Partners Pty Ltd had not been appointed general managers over these companies at the time of the Minsec collapse, and these companies were not involved in share-trading losses on the scale of the other member companies of the Minsec family which have been mentioned. Mineral Securities had acquired a controlling interest (SD per cent) in Aberfoyle Ltd during the 1969-70 year, and since Aberfoyle was itself the parent of a substantial group of companies (including Ardlethan Tin N.L., Cleveland Tin N.L., Golden Plateau N.L., North Australian Uranium Corporation N.L. and Paringa Mining and Exploration Co. Ltd), the acquisition brought into the Minsec Croup additional tangible assets of about $20 million and a flow current annual profits of more than $4 million, including the profits accruing to outside shareholders. Also in the 1979-70 year, Mineral Securities and Aberfoyle had acquired nearly 58% of the capital of the successful Cudgen R.Z. Ltd beach miner, and this in turn gave them control of a still more profitable beach miner, Consolidated Rutile Ltd in which Cudgen held just over 50 per cent. The combined profits of these two rutile and zircon producers (again including the outside interests) were running at a level of more than $5 million at the time and providing an even bigger cash flow, since their dividend payments were modest by comparison with the depreciation provisions. The Committee has received evidence which will be quoted later in this chapter, that Mineral Securities soon met opposition from some of the 'independent' directors of Consolidated Rutile over the proposed transfers of funds from that company to others in the Mineral Securities group, and that the objections of those directors were overruled. Late in 1970, Mineral Securities announced proposals to acquire all the outstanding shares in Aberfoyle and in Cudgen and Consolidated Rutile, but shortly afterwards withdrew the bid for Consolidated Rutile shares 'because it did not appear that unanimity of recommendation by that board would be reached'. The offers for Aberfoyle and Cudgen shares remained open up to the point of Mineral Securities' failure in February 1971 but were never proceeded with. In the liquidation of Mineral Securities, its holdings in the Aberfoyle group and in the two beach mining ccmpanies passed to overseas interests.

The broad indications are, therefore, that the stronger was the managerial influence of Kenneth McMahon and Partners on a member company of the group, the greater was the tendency for a portion of the company's resources to be directed into share market trading, either directly or through a transmission of funds to Mineral Securities. Kenneth McMahon and Partners did, of course, have several technical departments, staffed with persons qualified in mining exploration and mining engineering, and numbers of them were concerned in the management of companies such as Amad and Pexa Oil. There were three or four such technical departments, each with its own head, and above them was a Technical Committee. Mr McMahon supplied us with an organisational plan of Kenneth McMahon and Partners, listing in all six departments as follows: investment, mining engineering, mineral exploration, petroleum exploration, overseas, and group planning. Investment here stands for investment and share trading, and this was the department that showed by far the most spectacular profit results up to June 1970. The head of that department, Mr Nestel, was also the head of the 'group planning' department, and we have previously quoted the testimony that it was only through Mr Nestel, as head of the investment department, that Kenneth McMahon and Partners usually had formal communication with the board of Mineral Securities, and on that board Mr Nestel was the managing director. These structural features help to explain how a considerable part of the investment department's interest and enthusiasm for share trading percolated into the general management policies that the small private company of Kenneth McMahon and Partners was in a position to impress on member companies of the Minsec group, including some listed subsidiaries which had hitherto been purely mining companies.

The structuring also meant that the ideas, speculative judgements and strategies that were entertained by a small cadre of people in the George Street, Sydney, office of Kenneth McMahon and Partners were applied across the board to the share-trading operations of these companies. This gave the group scope for exceptionally powerful bursts of concerted action in the share market which tended to produce its temporary justification in sending market prices higher while the tide was favourable, but it left possibilities of reactions in the market after the concentrated buying bursts had subsided, and it left the group lacking such diversification of its investments against the contingency of mistaken expectations or onsets of adverse developments as might have been provided from a wider range of judgments and decision makers in these various public companies. The Minsec investment managers were about to put a vast quantity of eggs in a few baskets.

The organisational structure was not changed to take account of the rapidly increasing scale of an operation that represents the most ambitious and single-purposed essay in Australia to establish a continuous profit making business from speculation in the securities markets. Mr McMahon, in evidence, referred to the load that the expansion of group activities put upon the resources of his private company:

As time went by, and as the Mineral Securities group grew, it reached a stage where more and more time of the McMahon and Partners staff was being spent on matters of the Mineral Securities group. I attempted to keep a balance of 50-50. That became impossible. By the time of the Mineral Securities crash I estimate that between 80 per cent and 90 per cent of the time of the staff of Kenneth McMahon and Partners would have been spent on matters of the Mineral Securities group.

(Ev. 1206)

Still Mineral Securities remained in the physical sense a name upon a door. For all its enormous size on paper this public company lacked a distinct identity as a collection of persons, either at board or executive level. We found no evidence of proposals being advanced, even after the internationally known Mineral Securities had become a holding company for widespread mining operations, to reconstruct the company with a view to giving it an identity and personnel with defined, singly directed responsibilities for such aspects as the stable and balanced financing of the company's expansion. In these respects, Mineral Securities remained a nullity. Share-trading specialists continued to hold the lines of communication to the board and most of the effective authority for shaping the company. Very late in its life, as we shall see, strong recommendations for a re-structuring came from outside but were not given serious consideration in the conditions of crisis then developing.

Strategies of a Share-Trading Conglomerate

A Matter of Scale

To assist us in obtaining a measure of the size of share-trading operations conducted by the Mineral Securities group in its heyday, the Official Liquidator, Mr J.H. Jamison, took out some figures from records at his disposal. Mr Jamison's summary table (Table 14-1) of monthly transactions in the last thirty-one months of the group's activity, from 1 July 1968 to 8 February 1971, shows that Mineral Securities Australia Ltd and its two wholly owned subsidiaries, Minsec Investments Pty Ltd and Norausam Pty Ltd, effected share purchases totalling $180.3 million and sales yielding $104.3 million in that period. This does not include the share dealings made concurrently by Petroleum Securities Australia Ltd and its subsidiaries, which we have found in some cases of sustained group buying of particular stocks to have run at a level about one-quarter as high as that of Mineral Securities itself. Nor does it include the heavy share transactions of the two Minsec mutual funds and their share-trading subsidiaries, which began early in 1970; nor does it include trading by other companies in the group such as Oil Investments, Amad and Pexa Oil.

The figures also give an idea of the rising tempo of this market activity up to the end of 1970. Confining ourselves again to the trading of Mineral Securities and the two mentioned subsidiaries, in the year ended June 1969 the share purchases cost $51.4 million; in the following year to June 1970, the buying pace more than doubled to a total of $73.8 million; and in the six months to 31 December 1970, it again doubled to a total of $74.7 million for that period. The rate of movement in sales of shares tended to rise in similar proportion, usually running at about half the rate of purchases, except that in the 'Poseidon boom year', 1969-70, sales were two-thirds as much as purchases.

It will be explained shortly how some $13 million of both the stated purchases and sales for the six months to end-December 1970 were not transactions in the share market but represent a shuffle of shares in Robe River Ltd within the group, and mainly from the parent Mineral Securities to the subsidiary, Minsec Investments. When allowance is made for this, the trend of share dealing remains one of intense acceleration.

TABLE 14-1

INVESTMENT PURCHASES AND SALES OF MINERAL SECURITIES AUSTRALIA LTD AND TWO OF ITS SUBSIDIARIES, JULY 1968 TO FEBRUARY 1971

		Purchases	Sales
July	1968	1,656,959	766,507
August		2,655,497	495,661
September		1,076,562	1,056,139
October		255,841	681,385
November		1,646,159	671,717
December		1,522,772	1,445,998
January	1969	2,055,592	2,215,605
February		4,359,781	2,743,384
March		5,193,854	624,484
April		2,290,305	997,994
May		7,780,872	5,528,305
June		924,249	1,267,098
		$31,378,403	$16,494,275
		Purchases	Sales
July	1969	1,912,437	1,988,755
August		2,345,322	4,149,689
September		734,869	341,005
October		9,161,735	5,008,826
November		5,103,273	11,180,691
December		11,814,863	2,803,817

January	1970	5,058,957	8,601,241
February		3,156,640	10,744,537
March		2,941,922	1,713,036
April		2,309,184	1,023,965
May		766,854	811,860
June		50,504,587	3,342,614
		$73,808,643	$49,710,036

		Purchases	Sales
July	1970	4,993,283	13,574,709
August		878,177	3,762,879
September		25,888,159	2,097,634
October		20,353,555	9,232,244
November		12,706,801	3,055,874
December		9,908,572	2,847,206
January	1971	437,441	370,498
to 8th February		5,925	5,191,901
		$75,171,913	$38,132,945

These figures make it reasonable to infer that for the last eighteen months of its life Mineral Securities was the heaviest share trader that Australia has known. A few comparisons will help to suggest how much the heaviest. Late in 1970, the Committee heard evidence from Mr A.W. Coates, the investment manager of the Australian Mutual Provident Society, which is the largest life office and the largest known holder of listed company shares in the country. Mr Coates said that his society's rate of share purchases was about $40 million a year and its sales about $8 million (Ev. 682-686). Elsewhere we obtained evidence that the annual rate of share buying of what appeared to be the second largest life office and shareholder, the National Mutual Life Association of Australasia Ltd, was about $16 million (Ev. 1855). The figures which we have obtained from Mr Jamison for part only of the transactions of the Mineral Securities group show that in the twelve months ending December 1970 these companies made purchases of $107 million and sales of $47 million (excluding in each case the internal shuffle of Robe River shares~

This turnover of $154 million by itself is more than three times as much as the turnover given for the Australian Mutual Provident Society. If figures were available for the share-trading business of all members of the Minsec group in 1970, including the mutual funds, we believe the total would be not less than four times as much as those for the AMP Society and would exceed the turnovers of all life offices in Australia combined. These organisations were, of course, mostly operating in different sections of the share market from Mineral Securities. But in the Poseidon boom year, 1969-70, when speculative trading dominated the markets; it is reported that the total volume of business recorded on the Sydney Stock Exchange was $1,900 million; it would therefore seem that the Minsec group turnover would have represented the equivalent of something approaching 10 per cent of Sydney's volume in that record trading year.

Of course, Mineral Securities traded in other exchanges as well, but on the other hand it usually concentrated its forces on a narrow range of stocks at particular times, so that its effective share of the relevant turnovers was much higher, and it could dominate the markets in given stocks for months. In respect of the last months of the company's life, Mr Jamison was able to supply us with quantitative data illustrative of this. He took out figures showing that, of the $69 million of purchases made by Mineral Securities Australia Ltd and the two subsidiaries which we have previously named during the four months of September to December, inclusive, some $16.9 million was spent on shares in Queensland Mines Ltd, another $11.1 million on shares of Kathleen Investments (Australia) Ltd as part of the same operation to gain an influential position over the Nabarlek uranium deposits, and a further $21.9 million on shares in Robe River Ltd (or about $8 million exclusive of the switching arrangement in these shares). It will be seen later that these figures are to be supplemented by large purchases of the stocks which other member companies of the Minsec group made concurrently.

Mineral Securities was certainly not the only substantial organised trader in the booming speculative share markets of that period. Several of the other most sizable trading groups were built around share broking firms. We have examined data relating to some of them. We calculate that the scale of share trading done in the buoyant years 1969 and 1970 by the biggest one of the company groups which were associated with a broking firm would scarcely amount to one-fifth of the Minsec group's trading volume in those years. Again, the relative strength of Mineral Securities is apparent, though it is to be remembered that some broking firms, with their house-trading activities and their influence over clients' trading as well as their associated companies, may on occasions have been able to bring forces to bear on the market for particular stocks which were comparable with the power exerted by Mineral Securities.

The small cadre of investment advisers in Kenneth McMahon and Partners had a range of company instruments at their disposal for trading in the market. The unavailability of the group's daily records prevents us from assessing the tactics, if any, employed in orchestrating them, and our principal concern must be with broader aspects of the strategy developed for trading in the shares of subsidiaries of the group, on which we have obtained considerable evidence. Tactically, however, it is clear that the group traded on all the Australian exchanges and also in London. It often gave instructions direct to London brokers, though these were deemed as having notionally gone through an Australian broker (Ev. 1272). The group traded under several of its company names, with some additional pseudonyms, and traded through a variety of brokers, though for certain big operations it channelled orders predominantly through one or two brokers only. This might be done because a broking firm was thought to have a special relationship with a stock, having underwritten it or being represented on its board, or, generally being the recognised 'stable' for effective dealing in it

(Ev. 1190-91). But Mineral Securities' selection of brokers was in large degree an extension of its market influence. Examples will be given of brokerage commission business being directed to firms in reciprocation for subscriptions that the brokers had channelled from clients into the Minsec mutual funds, or in recognition of big lines of credit that Mineral Securities received from merchant banks which were associated with or controlled by the broking firms. Mineral Securities appeared to expect that some of the relationships established with particular broking firms would enable it to exert an occasional influence on the subjects to be treated in the brokers' circulars to clients ('Financial Evaluations', Committee Document 14-5).

TABLE 14-2

MINERAL SECURITIES AUSTRALIA LTD : SUMMARY OF CONSOLIDATED PROFIT ITEMS AND DIVIDENDS, 1965-66 to 1969-7.

(to nearest $000s)

	1965-66	1966-67	1967-68	1968-69	1969-70
Share trading profits	21,000	161,000	1,887,000	1,946,000	12,418,000
Mining profits (before deducting outside interests)	--	--	--	--	7,659,000
Mining profits (after deducting outside interests, approximate)	--	--	--	--	2,400,000
Interest & dividends received	6,000	28,000	46,000	124,000	415,000
Outside minority interests in group profits	--	--	303,000	523,000	7,220,000
Taxation provision	7,000	--	--	--	61,000

Consolidated net profit	21,000	161,000	1,584,000	1,425,000	12,707,000
Dividends paid Preference	--	--	--	61,000	215,000
Ordinary	--	33,000	91,000	221,000	555,000

14.20

It is appropriate to refer here to the nature and trend of Mineral Securities' profits, and to one effect this trend had in pushing the group towards further mineral commitments. The phenomenal course of the group's declared profits, and the principal elements of it, over the five full financial years of Mineral Securities' existence, are given in Table 14-2, prepared from information in the company's annual reports and the records of the Sydney Stock Exchange.

Next in significance to the remarkable increase in the declared share-trading profits from negligible amounts in the first two years to nearly $2 million in both 1967-68 and 1968-69 and then up sixfold to $12.4 million in the year ending June 1970, is the consistent avoidance of income-tax liability on the profits shown in the tables. This was largely achieved by Mineral Securities' subscription to new mineral share issues which were deductible from an Australian subscriber's taxable income under section 77 of the Taxation Act, as then framed. The greater the rate of profit growth from share speculation, the greater the amounts of subscriptions to the share issues of new or expanded mineral ventures that were needed to avoid paying taxation on the profits. By the latter part of 1969-70, such new share subscriptions to an amount of more than $12 million were necessary to avoid paying income tax of perhaps about half that amount which would otherwise have been chargeable. With company income tax at a standard rate of 47½ per cent, the saving in tax commitments could provide nearly half of the cost of the new share subscriptions, but this still required Mineral Securities to provide from its resources a sharply rising amount for the net difference of the necessary subscription moneys. A large part of the tax deductions in 1969-70 was obtained by subscriptions to the flotation of Robe River Ltd, in which Mineral Securities played an active sponsoring role. Taken by itself, and given restraint in other directions, the subscription of a net $6 million to such a project would present no liquidity problems to a company earning a year's net profit of $12.7 million and paying dividends of only $770,000 to its ordinary and preference shareholders. Moreover, the directors envisaged that Mineral Securities might enjoy very early profits from trading in the new Robe River shares, and we shall shortly see how market and other strategies were applied to this end. Yet it was not intended that Mineral Securities should substantially reduce its holding in Robe River. On the contrary, Mr Nestel in a private paper called 'Financial Evaluations', submitted to the board in October 1970, when plans were afoot to expand the scale of iron ore mining operations, made projections on the assumption that returns from the interest in Robe River would become the principal component of the Mineral Securities group's profit as from the year ending June 1973, when the estimated return from that source alone was $8.3 million. His projections showed the return from Robe River as rising to a peak of $18.9 million in 1975-76 and then levelling out at about $11 million in the years to June 1980. In the same document, Mr Nestel put the projections of profits from share trading at $6 million a year for the decade to 1980, subject to possible deductions of $3 million for 'interest and tax'.

The extremely small dividend distribution made from the great 1969-70 profit was such as to be taken by observers as a mark of general financial conservatism on the board's part, pointing up a contrast between appearances and reality which is to unfold.

Privileged Trading in the Shares of Subsidiaries

Whatever may have been the outside impression, Mineral Securities' visible policy of increasingly 'moving into the ground', that is of acquiring controlling interests in operating and producing mining companies, did not preclude it from continuing to be an active trader in the shares of those same companies.

On the contrary, we will quote evidence that the shares of subsidiary mining companies sometimes became more effective as speculative counters for Mineral Securities than these shares had been previously, as Mineral Securities gained insights into and influence over the companies' policies and tightened the supply of shares in public hands. In fact, one of the prominent reasons for the acquisition of a majority interest in some companies was the scope for profitable subsequent trading in their shares. This applied, for example, in the decisions to take a large and ultimately a majority interest in Robe River Ltd in 1970. Evidence relating to Mineral Securities' varying relations with that company over a four-month period will now be given, and we begin with a broad statement of policy in the testimony of Mr Nestel:

Senator Rae: Finally, in a few words, why did Mineral Securities go into Robe River?

Mr Nestel: In February-March?

Senator Rae: No. Why did Mineral Securities enter into the whole Robe River project?

Mr Nestel: Because it was our belief then - I mean it was February or March that Darlings approached us. It was my belief then and still is that it would have been an absolutely outstanding investment from a future cash flow and strategic position.

Senator Rae: How important to Mineral Securities was the opportunity to trade?

Mr Nestel: Very important.

Senator Rae: That is, trade in Robe River?

Mr Nestel: It was important.

Senator Rae: So that there were two basic reasons for going into Robe River in the way in which you did and the further extensions of the way in which you went into it. One was that you regarded it as an outstanding investment and the second was that it provided an excellent opportunity to trade; is that so?

Mr Nestel: The first one was the over-riding one, but the second one could not be ignored when for specific tax reasons, such a huge holding was in Mineral Securities itself. Had you asked me earlier, I would always stress the point that Mineral Securities as a trader sought to make profits each and every year and not just, if you like, every five years by waiting until Robe River got to $6 and then going and selling them all then. As it is probably evident from what I have said in the last two days, our view was that by taking profits in Robe River in 1970 one was going to take a lot of profits in PRA and the Nabarlek situation in 1971. I mean, that was our thinking at the time.

(in camera)

The Committee obtained some evidence of the policy of trading in Robe River to which Mr Nestel referred from our examination of the records of a Sydney broking firm, Hattersley & Maxwell. That firm transacted a large part of the agency broking business for Mineral Securities in this stock. The Committee found that throughout the period from the first trading on the exchanges in Robe River in August 1970 until the collapse of Mineral Securities in the following February, the group's trading in this stock through the one broking firm represented more than half of the total recorded turnover in Robe River shares on the Sydney Stock Exchange. The firm's buying and selling transactions on behalf of the Minsec group, but excluding those for the Minsec mutual funds, totalled 4,345,900 Robe River shares, compared with a total Sydney turnover of 8,404,000. This by no means gives the full extent of Mineral Securities' transactions in the stock; we have evidence, for example, that it placed large orders with the Melbourne broking firm, F.R. Morgan & Co.

In passing it is relevant to note that F.R. Morgan & Co. and Hattersley & Maxwell issued highly optimistic recommendations to their clients on Minsec (in the case of Morgan) and Robe River (in the case of Hattersley) during the last six months of

Minsec's life. Morgan's seventeen page review of Minsec in July 1970 made the improbable forecast of large share-trading profits continuing through to June 1975. For the five-year period, the 'conservative' forecast of profits from this activity was $35.7 million; the 'optimistic' forecast, $47.6 million. Our comment of this report is not flavoured by hindsight. Any sharebroker who forecasts the results of a share-trading company without allowing for the possibility of losses from such activities must expect criticism. The point we draw attention to is that this firm of brokers - a firm of mining specialists known for their emphasis on quantitative rather than impressionistic forecasts -did not warn readers of the possibility of share-trading losses; and readers were not to know that Morgans were carrying out a large amount of share trading for Minsec (not just in Robe River shares) and had a vested interest in that turnover continuing. Minsec was described as 'taking the classical approach of a mining finance house, using its profits from share trading to buy assets with a long-term cash flow potential'. According to Morgan, the company was 'on the threshold of becoming one of Australia's leading mining companies'. Hattersley's four page review of Robe River on 27 November 1970 said that the shares could be bought at $2.50 each but were worth $3.00. The newsletter to clients also contained accurate and detailed information about the Robe River venture which neither Minsec nor Robe River had revealed to shareholders or the public. Hattersley & Maxwell listed the volume of trading in Robe River shares on the Sydney exchange but again, readers were not to know what Hattersley & Maxwell knew, that Minsec itself had had a great deal to do with the high volume of turnover and with setting the current market price.

The detailed figures which we have taken from Hattersley & Maxwell are briefly summarised in Table 14-5. The table shows, first, the scale and proportion of the whole Sydney market of Minsec's trading in Robe River month by month, and secondly the major buying phases and selling phases of Minsec's operations related to the market prices of Robe River shares.

TABLE 14-3

TRANSACTIONS OF THE MINSEC GROUP, EXCLUDING THE MUTUAL FUNDS, IN THE SHARES OF ROBE RIVER LTD THROUGH HATTERSLEY & MAXWELL, IN WHICH HATTERSLEY & MAXWELL WERE ACTING AS AGENTS

	Monthly totals (buy plus sell) for Minsec	Sydney Exchange reported sales	Minsec dealings thru' Hattersley as p.c. of reported turnover
August, 1970	737,800	2,552,800	29%
September, 1970	2,047,100	5,582,200	60%
October, 1970	943,100	1,540,900	70%
November, 1970	517,100	721,500	72%
December, 1970	90,800	261,000	35%
January, 1971	10,000	145,200	6%
Total	4,545,900	8,404,000	52%

Minsec's buying and selling phases of Robe River shares through Hattersley & Maxwell related to market prices

	No. of Shares	Price Range
+ August 20, 1970 - September 4, 1970	872,100(sell)	$1.60-$2.00
September 7, 1970 - September 24,1970	1,728,400 (buy)	$1.60-$2.30
September 25, 1970	28,900(sell)	$2.15-$2.30
September 28, 1970 - October 9, 1970	405,500 (buy)	$2.18-$2.50
October 12, 1970 - October 13, 1970	10,900(sell)	$2.40-$2.50
October 14, 1970 - December 21, 1970	1,290,100 (buy)	$2.25-$2.55
December 22, 1970 - January 12, 1971	-	-
January 13, 1971 - January 14, 1971	10,000 (buy)	$2.00
January 15, 1971 - February 2, 1971	-	-
++February 3, 1971	700(sell)	$1.80-$1.85

+Date of listing of Robe River Ltd

++Date of delisting of Mineral Securities and temporary delisting of Robe River Ltd

The figures do not include the peculiar switching transactions involving some 6,000,000 Robe River shares between parent companies and subsidiary companies in the Minsec group, though these transactions were put through the same broking firm between October and December 1970. If the internally switched shares were added to both columns of the table which relates Minsec monthly transactions to the exchange turnovers, then the proportion that Minsec operations through this firm bears to Sydney turnovers would exceed 71 per cent. Of the transactions which are shown in the table, it will be seen that purchases substantially exceeded sales. Mineral Securities was increasing its equity in Robe River, in circumstances to be described shortly. Meanwhile, it is evident that Mineral Securities played the dominant part in establishing the stock exchange price (what is sometimes called 'making the market') of its subsidiary Robe River in this period. Mr Nestel, in his evidence, acknowledged this, after he had confirmed the quantitative scale of Minsec's operations such as we have quoted.

Senator Rae: The Sydney Stock Exchange was the principal exchange concerned with dealings in Robe River shares, was it not?

Mr Nestel: It was the principal one.

Senator Rae: So far as it was concerned, with 71 per cent at least of the trading being by the Mineral Securities group, Mineral Securities was the principal force establishing the price of the Robe River shares during the six-month period during which they were listed. Does that not follow?

Mr Nestel: I would accept that.

(Ev. 1383)

The Committee also discussed this matter with the Official Liquidator, Mr Jamison, who had made himself knowledgeable on the market status of Robe River shares. Mr Jamison did not think that Mineral Securities was responsible for the opening premium of 60 per cent which the market placed on Robe River shares in August 1970. He said: 'They were issued at $1 and they came on the market. The stupid public paid $1.60 for them the first day they came on the market'. After discussion on this point, the examination proceeded:

Senator Rae: Let us accept for the purpose of the exercise that they did not do anything at all to make the initial price of $1.60. From then on the stupid public, as you put it, having established a price~ Mineral Securities group entered the market and were involved in a very large number of transactions other than the transactions through Hattersley & Maxwell. In fact the calculation that we have is that of the total sales through the Sydney Stock Exchange in the period during which Robe River was listed ... something over 80 per cent of the total sales - that is including the Hattersley & Maxwell one - were on behalf of Mineral Securities group. It is hard to escape the prima facie impression that their activities must have been responsible for pushing the price up to near $5.

Mr Jamison: There is no doubt about that.

(Ev. 2892)

The next point that our inquiries have established is that Mineral Securities made a large part of these purchases of Robe River shares on the basis of privileged information which it was in a position to obtain in advance of the general public. Mr McMahon acknowledged this in evidence to the Committee (Ev. 1266-69). He related how Mineral Securities acting on advance intimations from inside the Robe River boardroom to the effect that very large increases in the iron ore project's scale of operations were under consideration, with the prospect of 'greatly enhanced profits' (Ev. 1266), quickly increased its holding in Robe River by about 2,000,000 shares so as to gain an outright majority. Mr McMahon also confirmed that the first announcement to the general public including Robe River shareholders, of the intention to work towards this large escalation of the Robe River plans, when it was confirmed, was made by Mr McMahon at a general meeting of shareholders in Mineral Securities in November 1970 (a month after that company had gained a majority of Robe River shares), and not to the shareholders of Robe River (Ev. 1267-68).

These events had occurred while the Committee was conducting its investigations into the securities markets, and known to be doing so. There was nothing in Mr McMahon's evidence to suggest that Mineral Securities regarded tactics of the kind he had described as being untoward in its dealings with shares of subsidiary or associated companies. He said that no questions had been asked by stock exchange or State authorities as to why the public announcement had been made in these circumstances, or about Mineral Securities' advance purchasing of Robe River shares (Ev. 1268-69).

The circumstances of Robe River's flotation are an instance where interlocking share holdings and directorates in public companies have been used to advantage one group of shareholders and disadvantage another. The interests of public investors in the newly floated company were subordinated to the interests and ambitions of Mineral Securities. In our subsequent examination of Mr Nestel, we extended to a more general plane the discussion of Mineral Securities' attitude to the use of inside information about subsidiaries for purposes of profitable trading in their shares. We propose now to explain the reasons for arriving at the conclusion that the Robe River was by no means an isolated case, but was regarded rather as an example of what was to be a consistent program for the use of subsidiary listed companies to make share-trading profits and to give Mineral Securities other advantages in borrowing and takeover powers.

Our discussion with Mr Nestel developed out of our interest in the contents of a handwritten document entitled 'Financial Evaluations' which had been prepared for the board of

Mineral Securities by Far Nestel and other members of the investment and group planning departments of Kenneth McMahon and Partners (Ev. 1516-17). The document is undated, but Mr Nestel told us that it had been prepared in advance of a board meeting on 27 October 1970 (Ev. 1541-42). It was one of the Mineral Securities documents of which copies came into our possession.

The opening pages of 'Financial Evaluations' set out proposals for what were called the 'Acquisition Time Table' and the 'Group Philosophy' of Mineral Securities Australia Ltd. We quote first the 'Acquisition Time Table' in full. It is significant for setting out a program for share buying in subsidiary companies in advance of a series of proposed, precisely timed announcements by the subsidiaries which would be expected to lift the values of their shares. The text reads as follows, with some explanatory expansions of the abbreviations supplied in square brackets and a gap where one word is illegible to the Committee:

<u>Acquisition Time Table:</u>

Sept 1970 - *MSAL Board resolves to increase its holdings in "group" companies.

*In consequence buying on market of following stocks gets under way -

Aberfoyle
Ardlethan
Amad (small)
Cleveland Cudgen
Cons Rutile
G. Plateau (small)
Oil Inv.
PSAL [Petroleum Securities Australia Ltd]
Pexa (small)
Paringa (small)
R. River
*Group Planning Department undertakes review of possible expansions and also undertakes valuations.

Oct 27 1970 - MSAD Board to review position

Oct 27 1970 -	Robe River Ltd releases qtrly [Quarterly report] and is now a subsidiary of MSAL
Nov 4 1970 -	Mincast Holdings P/L formed
Nov 5 1970 -	Aberfoyle & Cleveland AGMs [annual general meetings] and Cleveland announces expansion
Nov 13 1970 -	PSAL AGM, indicates incr. RR [increase in its Robe River] holding (to 5%), parent coy trades profitably, and forewarns diversification (e.g. A.J. Chown? [illegible] etc)
Nov 16 1970 -	Consol Rutile announces expansion
Nov 24 1970 -	MSAL AGM indicates RR expansion, trading profitably, enlarge on importance of Cleveland, Con. Rutile expansion to MSAL, refer to Mincast Holdings P/L, Western Ventures.
Dec 1 1970 -	Bids + Brokers' Circulars
Dec 1970 -	Castlemin Ltd formed
Dec 1970 -	Approach Burns Philp etc re MSAL placements

This time table, prepared in advance of the events it catalogues, takes the strategy which we have described in the Robe River case to yet a further stage in exploiting the share market. Mineral Securities' management here proposes not merely to buy shares on the receipt of privileged inside information affecting the subsidiary companies, but even to help to devise and create or to influence the 'inside' decisions and developments in the subsidiaries which would affect the share prices after the purchases were made by Mineral Securities. Consideration was evidently given to extending beyond mineral investments into companies such as the old-established Sydney merchant business of A.J. Chown Holdings Ltd. As we have previously noted, one of the directors of Mineral Securities, Mr E.D. Spooner, was the deputy chairman and a senior executive of the Chown business. (The Minsec group had invested $290,000 in A.J. Chown by late 1970). Mr Nestel also appears to have expected favourable references to the shares of Mineral Securities in brokers' circulars to coincide with some of the company's takeover bids early in December 1970.

The last entry in the 'Acquisition Time Table' indicates an intention to approach the wealthy merchanting and investment business of Burns Philp and Co. Ltd for funds in exchange for share placements. The chairman of Burns Philp, Mr J.D.O. Burns, had become associated with Mineral Securities in the sponsoring of Robe River Ltd, and he sat on the board of that company with Messrs McMahon and Nestel.

Before giving consideration to Mr Nestel's testimony to the Committee relating to the time table, it will be appropriate to note the other principal contents of the 'Financial Evaluations' paper. In particular, the 'Group Philosophy' expressed by Mr Nestel deserves to be quoted. It lists a range of advantages and some disadvantages to be expected from increasing the Mineral Securities holding in subsidiary companies. Some of the points in this section would be applicable to a full takeover, while some of the other quoted advantages would relate rather to buying operations which fell short of complete acquisition of a subsidiary's shares. The latter applies to the suggestion that increased holdings of subsidiary shares would, first, enhance their market prices as the result jointly of the buying process and the reduction in the number of shares circulating, and secondly that the higher values of subsidiaries would enhance the parent Mineral Securities' own market rating and borrowing potential. While the paper does not specify which subsidiaries are to be bought outright and which ones left on the exchange lists, those subsidiaries with the word 'small' written in parenthesis with their names in the time table would evidently fall into the latter class. As we have already mentioned, Mineral Securities made bids about two months after the writing of this paper for all the outstanding shares in the relatively independent subsidiaries, Aberfoyle, Cudgen and Consolidated Rutile. In any case, the suggested 'group philosophy' seems to have been that the outside holdings of subsidiaries in general should be no more than a tight 15 per cent.

This second section of the document reads as follows:

Group Philosophy

To increase holdings in group companies to 85 - 100%

Advantages to MSAL

* Increases consolidated profit
* Improves borrowing capacity
* Strengthens base for further group expansion
* Minimises conflicts of interest in future allocation of new ore reserves
* Makes easier the allocation of 77D benefits to group companies with tax problem
* In long term builds up good will of minority shareholders
* Upgrading market value of subsidiaries (through consistent buying, scrip shortage, generous div. policy) provides collateral for MSAL loans as well as upgrading Net Asset Backing of MSAL
* Indirectly gives opportunity to Funds and related institutions to invest in group

Disadvantages to MSAL

* Issue of extra MSAL scrip (although it does go to solid shareholders)
* Criticism of minority shareholders.

After the exposition of group 'philosophy', the sections of the 'Financial Evaluations' paper which were written by Mr Nestel deal, first, with proposals for a joining of the forces of Mineral Securities and Castlereagh Securities Ltd, the company whose association with the Sydney broking firm of Patrick Partners is described in preceding chapters, to acquire dominant holdings in the Nabarlek uranium deposit, and secondly with the funding and technical financing requirements to achieve the program.

The funds were seen as coming from a combination of methods: more long-term debt; issues of Mineral Securities as payment for takeovers; placements of shares with 'Burns Philp etc'; an 'equity issue' (presumably a rights issue); and by the 'disposal of some existing holdings to "friends"'.

The funding methods immediately led the writer of the paper to consider a tactical problem arising from the expected increase in the quantity of Minsec shares. His final thoughts, under the heading 'Technical', imply that such increased supply~ or the known prospect of it when the takeover and issue announcements are made, should not be allowed to produce the effect of weakening the prices of shares in the group, and especially the shares of Mineral Securities, but that means should be sought to have these share prices specially supported by some buyers. This brief section of the paper reads:

<u>Technical</u>

* MSAL market could be weaker during currency of bids
* Who will buy group coys during currency of bids
* Who will buy MSAL up to Dec I to ensure that MSAL/group relation pricewise is reasonably maintained.

When Mr Nestel was asked to give evidence to the Committee on the interpretation of the 'Financial Evaluations' paper, he was first asked whether the terms of the Acquisition Time Table did not imply an intention that Mineral Securities should buy on the market shares in companies which were already subsidiaries at a time when Mineral Securities, but not the public shareholders, would know that these companies would later announce expansion developments and that the expansions were likely to influence the share prices. Mr Nestel said that it 'must always be open to interpretation as to how the market will view' such announcement (Ev. 1360). He said that 'it is always ... anticipated in a share price ... that production will increase', and that the matters of 'real significance' to the share market would be new mineral discoveries. He said that knowledge of a subsidiary's proposals to increase production 'would be fairly readily available to suppliers of equipment ... or they would be available to objective people who make visits to these mines'. The evidence proceeded:

Senator Rae: Then if I can just get clear as to this: The effect of the position is still that Mineral Securities was proposing to buy shares on the market prior to public announcements being made where they had the information which was to be contained in those public announcements.

Mr Nestel: Yes.

(Ev. 1561)

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Senator Rae: I draw your attention to the words you have used in the document. The words are: 'Who will buy group companies during currency of bids?' Those are the words used, are they not?

Mr Nestel: Yes. That is during the currency of the bid. That is after the bid is announced ...

Senator Rae: The specific consideration is: Will there or will there not be any buying during the currency of the bid?

Mr Nestel: That is correct.

Senator Rae: Was any consideration given to the question of whether it was necessary to support on the market the price of Minsec shares during the currency of the bid?

Mr Nestel: There was interest given prior to the currency of the bid. This is what is noted in who will buy Mineral Securities up to 1 December, which was the envisaged day, the day on which the bid would be made public. Beyond that period it was felt that as it was a share exchange offer only - so many Mineral Securities shares for so many Cudgen shares - that that price of the two, if I could put it, would become locked together and therefore there was no material significance to Mineral Securities as to what Mineral Securities' share price did.

Senator Rae: I will read the whole of the point that is mentioned in your paper at page 4. It states: 'Who will buy MSAL up to December 1st to ensure that MSAL group relation pricewise is reasonably maintained'. It is the elaboration of that which you have just given, which, as I understand it now, is that up to the time of the takeover bid being made public, which was anticipated to be 1st December, the board of Mineral Securities was concerned to ensure that the market price of Mineral Securities shares was maintained and did not decrease?

Mr Nestel: Was maintained at a reasonable level around, yes.

In a subsequent discussion of the 'group philosophy' section of his paper, Mr Nestel said that Mineral Securities would only buy additional shares in subsidiaries 'if our valuations indicated to us as general managers that they were underpriced on the market'. It would then follow that 'the consistent buying would in fact lead to the market price presumably moving up closer towards what is our valuation - the true value of the stock anyhow' (Ev. 1362). He said that one occasion when Mineral Securities would not buy shares of a subsidiary was in the period between taking a decision to make a formal bid for the outstanding shares and the public announcement of the bid (Ev. 1363-64). The examination continued:

Senator Rae: That envisages that they would take any steps regarded as reasonably necessary to maintain the level of the price of Mineral Securities shares on the open market during that period up to 1 December?

Mr Nestel: Yes.

Senator Rae: Were any steps taken, directly or indirectly, by the board of Mineral Securities to maintain at what was regarded as a reasonable level the price of Mineral Securities shares during the period from late October 1970 to 1 December 1970?

Mr Nestel: Yes.

Senator Rae: What steps were taken?

Mr Nestel: In the first place, no company purchased any Mineral Securities shares, as I explained earlier. We refrained completely. Mr Alexander of Hill Samuel was at this meeting from London and he felt that as Hill Samuel had many clients who had shares and he was very happy with the price at these levels he could well, on behalf of some clients, acquire some shares in Mineral Securities at what he judged were very reasonable prices.

Senator Rae: So, the step taken to maintain the price level of the shares in Mineral Securities at what was regarded as a reasonable level was the buying by clients of Hill Samuel of Mineral Securities shares; is that the position?

Mr Nestel: Yes.

Senator Rae: Is that the only step which was t~cen?

Mr Nestel: The only other one to my knowledge was that, I believe, just as Mineral Securities had a sizable holding in Castlereagh Securities shares that Castlereagh Securities itself looked at the purchase of Mineral Securities shares.

Two matters arising from the latter part of Mr Nestel's evidence which has just been quoted require immediate comment. First, the merchant bank of Hill Samuel has written to the Committee strongly rejecting any suggestion that it had a part in supporting the market for Mineral Securities. We were told, that during the period between mid-October 1970 and 1 December 1970 Hill Samuel & Co. Limited had no dealings as a principal in the ordinary and preference shares of Mineral Securities, and that, during the same period, Hill Samuel & Co. Limited acting on behalf of clients was a net seller of Minsec shares. Secondly, we have examined documentary records of the two mutual funds which were launched by Mineral Securities and had three directors in common with it, showing that the funds bought large amounts of Mineral Securities shares from late September to the end of October 1970, that is during and shortly after the time of preparation of the 'Financial Evaluations' paper. The total cost of these purchases, made over a period of about five weeks through various brokers, was more than $1,300,000. They occurred after a lapse of five months in the case of the First Australian Growth and Income Fund and three months in the case of the Second Australian Growth and Income Fund, since the funds had previously bought shares in their sponsor, Mineral Securities, and they had the effect of raising the proportion of the funds' investments that was committed to the fortunes of the Minsec group to well over half the total investments. The reasons for the mutual funds' heavy additional purchases of Mineral Securities' shares in September-October 1970 have not been explained. They were made at a time when the directors of Mineral Securities, and therefore a majority of the boards of the funds, knew that their company's real profit trend had turned adverse. The greater part of the purchases were made on behalf of the holding sections of the two funds, rather than their trading sections. The purchases had the effect of strengthening the market in Mineral Securities' shares and reducing the supply in circulation, immediately before any discussions would have been held to encourage buying by outside parties on the lines suggested in Mr Nestel's evidence.

After studying the documents available to us and hearing witnesses, the Committee has reached the general conclusion that Mineral Securities made use of a uniquely privileged access to information relating to the affairs of Robe River, to trade profitably in the shares of that company, and that this practice was tending to become a systematised part of the Minsec group's programmed strategy in the last year of its existence.

The claim by Mr Nestel, that Mineral Securities did not buy subsidiary shares between the time of a formal board decision to make an offer for the outstanding shares and the time of announcing the offer, is of minor importance if the board proposal to make the offer had been adopted and purchases of the shares effected well before the formal, minuted board decision as to the terms of the offer. Mineral Securities would still have acted on advance information. Again, despite Mr Nestel's suggested qualifications, Mineral Securities was in an unparallelled position to exploit information of a precise and comprehensive nature on the future policies and announcements and on the current experiences of mineral producing and exploration companies in the group. By comparison with the controlling parent company's knowledge, such hints as the 'suppliers of equipment' or 'people who make visits to the mines' would pick up, would usually be tentative, fragmentary and late; and in any case such people would have little or no identification with the body of public shareholders of the subsidiary companies to whom the directors of the subsidiaries, including the Minsec representatives on the boards, had a responsibility. The explanations given by witnesses from Mineral Securities on this matter were entirely unsatisfactory, and raised general questions regarding the future conduct of listed subsidiary companies to which we shall have to return at the end of this chapter.

<u>Concealment of Loss Fabrication of Profit</u>

Few companies can ever have experienced as sudden and draftic a reversal of profit trend as Mineral Securities began to experience after the first weeks of the new financial year in July 1970. Though the public had no inkling of it, the directors had reason to know that the real share-trading profit in the year ended 30 June had been $15.2 million instead of the declared figure of $12.4 million, but that the annual rate of loss being suffered in the first half of 1970-71 was running at more than $10 million. From the records available to us, it appears that a large part of the explanation can be summed up in the word 'Poseidon' and all that it connoted for nickel and other speculative sections of the market. Mineral Securities' direct losses on trading in Poseidon shares at this time were not large by comparison with the profits the stock had apparently brought it a few months previously. In anticipation of a good quarterly report from Poseidon and other favourable developments in the market, Mineral Securities had come back as a buyer of the shares in June and early July at prices ranging from about $127 to $135 a share and at a cost of about $8 million. Before the end of July it had sensed the change and began to take its losses fairly quickly, selling at an average price of about $88, and even going on, apparently, to sell Poseidon short in August, again without profit. By September, it had covered any short selling, and was out of Poseidon, having bought a total of 72,540 shares in three months and sold the same number for a loss of about $2.8 million. We are indebted to Mr Jamison for the figures in Table 14-4.

TABLE 14-4

MINERAL SECURITIES AUSTRALIA LTD: PURCHASES AND SALES OF POSEIDON SHARES, JUNE TO SEPTEMBER, 1970

	Bought			Sold		
	No. of Shares	Value $	Average Buying Price $	No. of Shares	Value $	Average Buying Price $
June	35,564	4,547,993	127.88	566	72,450	128.00
July	27,276	3,679,754	134.90	51,508	4,565,541	88.63
August	1,815	133,017	73.28	20,466	1,591,509	77.76
Sept.	7,885	640,936	81.28	566	72,450	128.00
	72,540	$9,001,700		72,540	$6,229,500	

A loss of less than \$5 million was not in itself crippling for a company that had won profits of \$15 million in the year just ended and paid out dividends of less than \$1 million. Nevertheless the fall of Poseidon's price in a period of credit tightness marked a change of climate on those fronts of the share market where Mineral Securities operated. The times were no longer propitious for share trading, in dramatic contrast to the conditions of the previous nine or ten months. This posed a number of questions for a professional share-trading company, and especially for one that had set new records of profit making, as to what it should and should not do while such conditions prevailed. It might have sensed new constraints appearing on its ability to borrow. By 30 June 1970~ Mineral Securities had not drawn more than one or two million dollars from the short-term money markets, though it owed about \$24 million to various current creditors, of which no less than \$13.2 million was owing to brokers and \$5 million to the mutual funds and other associated companies. The questions which had not previously been tested were how the share market rating and the borrowing status of a listed share speculating company would be affected by the knowledge in the markets that it was having an unprofitable experience in that profession, though it was still drawing dividends from its mining interests.

The questions were not put to the test. Instead of preparing for the disclosure of its lean experience, Mineral Securities set about distorting the public picture of its profit trend and plunging into the short-term money market to a depth that no Australian company had done in order to make massive purchases of shares in mineral prospects. An explanation of the motives and reasoning behind that course of action is beyond the scope of this chapter. We are concerned with the methods employed, and the implications for the financial and investment markets. We turn first to the practices which the company employed to conceal the reversal of profit trend from shareholders and creditors and from mutual fund and other investors.

Backdating the Poseidon Loss

By the time that Mineral Securities was due to report its results for the year ended June 1970, the directors knew that the company had lost about $2.8 million on Poseidon shares since the close of that year. They decided to deduct an amount of approximately that size from the profits to be declared for the 1969-70 year. The actual share-trading profit of about 415o2 million which had been earned was accordingly published as one of $12.4 million.

Not only had all the Poseidon shares been sold in the following, 1970-71 year, but rather more than half of them had also been bought after the end of June 1970, according to the information supplied by Mr Jamison. No indication of any abnormal deduction having been made from the 1969-70 declared profit was given in the profit-and-loss statements in the annual accounts for that year. Among the notes appended in small print to the company's balance sheet as at 30 June there was a sentence saying that 'Market value of the investments of the group has been calculated on the basis of the last sale price of each stock on 3Oth June 1970~ with the exception of one stock which has been further written down in the light of post-balance date events to the realised value'. If this statement was referring to the Poseidon transactions, it was uninformative or misleading in several ways. It gave no indication of the amount involved in the adjustment, nor any indication of the bearing, if any, that the adjustment had on the declared profits, and it would be taken by readers to apply to stocks actually held at 30 June, and not to any stocks that might have been bought after that date and subsequently sold at a loss. This was the sum total of the references made publicly in the annual report and anywhere else to the treatment of the Poseidon loss. The auditors, Bowie Wilson, Miles & Co., gave unqualified endorsement to the manner of the presentation of the accounts. They certified that the balance sheet and profit and loss account of Mineral Securities and subsidiaries were 'properly drawn up ... so as to give a true and fair view of the state of the company's affairs as at 50th June 1970, and of the results of the company and the group for the year ended on that date'.

We have been astonished that auditors should have said that the profit and loss account for Minsec for the year ended June 1970 was 'true and fair'. In our view, the accounts were not 'true', and we cannot see how, in the circumstances, the auditors were properly fulfilling their role as the guardians of the shareholders and the public.

The absence of constraints on the Mineral Securities board at that time seems to have been one of the turning points in the company's history. The main significance of this distortion of the 1969-70 accounts was for the assistance it gave directors of Mineral Securities not only in concealing from everyone else the fact that there had been a change in the company's share-trading experience but in proceeding to make positive statements that substantial profits were being earned. Some of the evidence we heard from Mr McMahon (Ev. 1258-59) concerning the treatment of the Poseidon loss will be mentioned later, when the significance of the episode as a possible turning point in the company's policies may be gauged.

Meanwhile, it is necessary to observe another serious aspect, the special involvement of the two Minsec mutual funds directly and indirectly in the Poseidon losses. The mutual funds had invested in Poseidon shares concurrently with Mineral Securities, evidently on the same expectations of a good interim report and other possibilities. Mr Nestel was unable to remember how much the funds lost on Poseidon (Ev. 1379). We have examined the records of the two trading arms of the mutual funds

(First EFA Traders Pty Ltd and Second EFA Traders Pty Ltd), in June to August 1970. These show that the combined losses amounted to $530,539, which represented an appreciable part of their total resources. Three of the directors of these mutual funds were also directors of Mineral Securities. Yet it was after the losses on Poseidon had been suffered by both the company and the two funds, and after further evidence of unprofitable trading conditions for Mineral Securities that the funds were made to invest another $1.3 million in shares of Mineral Securities in September-October 1970.

Shuffling Robe River through Hattersley & Maxwell

By the time that Mineral Securities' accounts for the year ended June 1970 appeared with the concealed profit adjustment, the directors were well advanced in a more elaborate operation, and one with no less remarkable accountancy heterodoxies, as part of the attempt to sustain a facade of continued share-trading success. This was a process aimed at selling about 6,000,000 shares in Robe River Ltd, so that Mineral Securities could declare a profit on them while still retaining the shares in the hands of a wholly owned subsidiary. It involved the collaboration of a broking firm, Hattersley & Maxwell of Sydney. Mr McMahon told us that Mineral Securities had at first been minded to sell outright substantial quantities of Robe River to obtain trading profits which would offset the other losses it was experiencing in the market. But when it learned of the plans for expanded output and greatly enhanced profits' from Robe River, this policy was changed (Ev. 1266). From this point, it appears that the negotiations with Hattersley & Maxwell began.

The share shuffling processes arranged with the broking firm can be briefly illustrated by reference to the three principal sets of transactions which accounted for most of the 6,000,000 Robe River shares that were moved around. We have taken the following information from the records of Hattersley & Maxwell. On each occasion the formal buyer of Robe River shares from either Mineral Securities or Petroleum Securities Australia Ltd, in the first place, was deemed to be Hattersley & Maxwell, acting as principals. Then Hattersley & Maxwell was claimed to be re-selling the shares as principal to a wholly owned subsidiary of the Minsec group, either Minsec Investments Pty Ltd or Petsec Investments Pty Ltd (Ev. 1278-79).

In the first and biggest of the three rounds, the Minsec parent companies sold 5,250,500 Robe River shares to Hattersley & Maxwell during the week from 12 to 19 October 1970. This was less than two months after Robe River shares were first listed on the exchanges. The value of the sales, recorded as being at prices between $2.58 and $2.48 per share, was calculated as being $7,828,678. In the following week, between 22 and 26 October, the Minsec group through the two subsidiaries bought back all these shares from Hattersley & Maxwell in five contract notes recording a total value of $7,860,050. That left an apparent margin of $31,372 on the turn (Ev. 1279).

In the second round, following the same procedure, the Minsec group sold 2,152,300 Robe River shares to Hattersley & Maxwell as principals on 27 November and 2 December for $5,442,716. The Minsec group bought back all these shares between 3 and 14 December, the price being $5,453,879, and leaving a margin of $16,163. In the third transaction, the Mineral Securities group on 15 December sold 100,000 Robe River shares to the brokers as principals for $255,000; and on 16 and 17 December the group bought them back at exactly the same price.

Summarising these three rounds, the Mineral Securities group over a period of about three months sold 5,502,600 shares in Robe River. This was equivalent to more than half the number of shares on issue to the general public (Ev. 1280 & 1281). The total value put on the sales was $15.5 million. As Mineral Securities had obtained many of the shares at par (one dollar) and the balance below the prices quoted for the October-to-December transactions, it now purported to have made a profit of about $5.5 million from these three transactions (Ev. 1280). Other deals of a similar kind, on which we do not have full records, raised the total number of shares switched between members of the Minsec group in this manner to more than 6,175,000 and the claimed profit to $6.6 million (statement by directors of Mineral Securities, 4 February 1971).

Hattersley's & Maxwell's apparent margin on the three sets of transactions we have listed was about $47,500. In fact, the firm's senior partner told the Committee, none of the $47,500 was profit for Hattersley & Maxwell, but this sum was used for the most part to meet portion of the stamp duty costs incurred in the transactions; the balance of stamp duties, which amounted in all to about $78,000, was paid directly by Mineral Securities. Had the firm been acting as agents and claimed the standard brokerage commission rates, these would have been about $271,000.

There had been no money payments made by either party in the round of transactions, apart from a Minsec cheque to Hattersley & Maxwell to meet part of the stamp duty costs. Nor had there been any production of share scrip or registration of transfers in relation to the scrip (evidence of Mr John Bruce Gibson, general manager of Hattersley & Maxwell, Ev. 1841-42).

When the senior partner of the broking firm, Mr Kenneth Tolson Maxwell, was asked whether his firm had not been at risk, and on one occasion for nearly $8 million, dependent on Mineral Securities' ability to honour an arrangement to buy back the Robe River shares, he replied: 'We were not at risk, because we had the verbal arrangement with the Mineral Securities group that they would buy these shares back after a few days' (Ev. 1842). He referred to the question as being hypothetical.

Senator Rae: Although my question is hypothetical, I do not think it is unreal to put it, because is there any reason why you would not have perhaps undertaken this same arrangement in late January of 1971 if they had come to you at that time and asked you to do it then instead of coming to you in early October and asking you to do it? One only has to accept that to see that the risk was not so hypothetical.

Mr Maxwell: I suppose it would. As you say, if it had come late in January, well certainly it would have existed ...

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Senator Georges: And you did it for no consideration?

Mr Maxwell: No consideration at all.

Senator Georges: And you term that to be good business?

Mr Maxwell: It was something that we were asked to do by a company of high standing, and we looked at it and considered it was in accordance with the rules and that it was a proper transaction and we were doing a service to the company.

Senator Georges: Did you ever offer this to any other firm? Did you do it for any other group at any time?

Mr Maxwell: We have never offered anything like that. This was made at their request.

Senator Georges: Have you had at any time a request from any other company in this way?

Mr Maxwell: Not to my knowledge

(Ev. 1842-45)

The Committee inquired as to the basis and method for the computation of the various prices for Robe River shares which were quoted on the contract notes. The general manager of

Hattersley & Maxwell replied: 'To the best of my knowledge there was no calculation. That would have been approximately the market price at that time, I would have believed' (Ev. 1845).

Mr Maxwell confirmed information we had received that the sales slips prepared by his firm in relation to the transactions in Robe River shares had been handwritten instead of being passed in the usual way for processing by the stock exchange computer and had been marked in a manner to ensure that the transactions would not be incorporated in the stock exchange's turnover figures for publication. He said this was because the firm had regarded them as being 'special' transactions in terms of the exchange by-laws, but it had since found that the rules required a broker to lodge a 'completion slip' with the exchange (Ev. 1856-58). Later, when the character of the dealings had become public knowledge in the light of the Mineral Securities crash, the Sydney Stock Exchange held discussions with Hattersley & Maxwell, and the firm formally reported the transactions for inclusion in the recorded turnovers. This publication was made in March 1971, some three months after the last and five months after the first of the shuffling operations in Robe River shares (Ev. 1857-58). By that time the directors of Mineral Securities had accepted legal advice to the effect that Hattersley & Maxwell had not been a principal in the buying and selling of the Robe River shares but that the parent Minsec companies had sold to their subsidiaries. We are informed that the exchange imposed a substantial fine on Hattersley & Maxwell for technical breaches of exchange rules relating to the reporting of transactions and the charging of commission.

Before commenting on the Robe River share transactions, we briefly review the train of events which led up to these legal and technical rulings being given regarding their nature.

When the annual general meeting of Mineral Securities was held in Sydney on 24 November 1970, nearly five months of the company's unprofitable current half-year for share trading had passed. By that time also, more than half of the shuffling process in Robe River shares between companies in the Minsec group had been effected, and, of course, the loss of $2.8 million on Poseidon shares incurred since 50 June had been invisibly passed back and buried in the previous year's accounts. In his prepared chairman's address to the annual meeting, Mr McMahon, after referring to the profits shown for 1969-70 went on to say:

It may not be possible for the company to maintain that position in the present year. However the plans are now being laid to allow me to predict with confidence that in the not too distant future, profits earned will in fact improve significantly on those of the year under review, regardless of the vagaries of the market.

For the year to date, the company's net profits from both mining operations and share trading have been maintained at satisfactory levels. As pointed out previously, it is envisaged that the company's net profits from mining operations will be higher this year than last year. It would be quite important to forecast the extent of share trading profits that your company expects to earn in the present year.

The chairman's statement that net profits from share trading in the current six months had been 'maintained at satisfactory levels', implying that these profits were not greatly different from those in the corresponding period of the previous year, indicates that some of the directors at least were by this time clear in their minds that the profits to be claimed on the Robe River switchings would be included in the formal profit statement for the half-year. The arithmetic of the company's experience at the time, to be mentioned shortly, admits of no other conclusion, and indeed the switches had been obviously carried out with this prospect in mind.

14.49

A formal statement on the half-year's profit was issued as part of a notice to shareholders on 25 January 1971. It singled out for repetition the sentence in the chairman's speech to the annual meeting which had said that the company's net profits from mining and share trading had been well maintained, and without any further comment on trading conditions it reported an overall profit figure for the six months to 51 December which was three-quarters as high as that in the corresponding half of the previous financial year. The relevant section of this message to shareholders reads as follows:

HALF YEARLY PROFIT

At the Annual Meeting in November 1970, the Chairman stated that 'For the year to date, the Company's net profits from both mining operations and share trading have been maintained at satisfactory levels'.

The consolidated net profit, subject to audit, from both mining operations and share trading of Mineral Securities Australia Limited and its subsidiaries for the 6 months ended 51st December, 1970, was in excess of $5,500,000 after deducting the minority shareholders' interests, provision for tax and writing down the share trading portfolio to the lower of cost or market value. This compares with $4,775,000 for the corresponding 6 months ended 31st December, 1969.

The interim report of the Company giving details of the profit and of the various activities of the Group will be issued in February.

While the declared half-year's profit of more than $5.5 million was declared 'subject to audit', Mr McMahon told the Committee on more than one occasion of his understanding that, in principle, the inclusion of the claimed profit from the switching of Robe River shares inside the group 'had been cleared with the auditors', who were thought at that stage to share the assumption that 'the transactions were all proper and free' (Ev. 1192 & 1273).

He said that Mr Nestel had informed other members of the board that the auditors accepted a distinction which had been put to them between 'sales of Robe River shares by Mineral Securities as a trader and purchases of Robe River shares by Minsec Investments Pty Ltd as a long term investment', though he did not believe that a written report had been received from the auditors (Ev. 1273). We received similar evidence from another director of Mineral Securities, Mr E.D. Spooner (Ev. 1885).

Mr McMahon also said that he was not aware until 1 February 1971, that is a week after the half-yearly profit statement had been issued, that Hattersley & Maxwell had acted as principals in buying the Robe River shares from the Mineral Securities group in selling back the shares to the group. He said that Mr Nestel had revealed this in the course of answering a series of questions from Mr Spooner. 'This was the first knowledge I had', Mr McMahon said, 'that there was any element other than proper and free trading about the Robe River share transactions' (Ev. 1195).

Mr Spooner supplied us with the most detailed account of the events leading up to Mineral Securities' public disclosure of the Robe River transactions and its withdrawal of the half-yearly profit statement (Ev. 1884-86). Mr Spooner said that when he first became aware of the concurrent selling and buying of Robe River shares between companies in the group late in October, he 'raised the advisability' of the procedure and of the incorporation of profits from it at a directors' meeting. He was supported in his questions by Mr Richard Swift, the other chartered accountant on the board. On that occasion, and again when he questioned the procedure shortly before Mr McMahon's speech to the annual general meeting on 24 November, his objections were not accepted. He had again raised the question before the half-yearly profit statement was issued on 25 January 1971, and yet again at a board meeting on 1 February, when he learned for the first time of the part that Hattersley & Maxwell had played as principals. Mr Spooner said he regarded that information as clinching the case against inclusion of the $6.6 million from the Robe River turnover in the half-yearly profit. He said that Counsel's advice was obtained from Mr Russell Bainton Q.C. on the morning of 2 February, and 'Mr Bainton advised that in his opinion there was no sale by Mineral Securities to Hattersley & Maxwell and no sale by Hattersley & Maxwell to Minsec Investments, and that therefore the transactions were equivalent to a sale by Mineral Securities to Minsec Investments ... Mr Swift and I then took that one step further and said: "This profit is one which cannot be consolidated". Mr Bainton did not agree with that view, but as accountants we were quite clear that, if it was a sale by the parent to the subsidiary, then the resultant profit must be excluded on consolidation. But that was the board's decision and not eounsel's advice' (Ev. 1886).

In their fateful public retraction of 4 February 1971, the directors said that Mineral Securities had sold 6,175,900 shares in Robe River 'through brokers at the then current market value', while its subsidiary, Minsec Investments, had bought 6,575,000 shares in Robe River 'through brokers at current market prices'. Senior Counsel had now advised them that 5,195,400 of the shares bought by the subsidiary must be treated as having been purchased from the parent company. Consequently, 'the profit of $6,650,000 earned by the company on the sale of these shares is to be eliminated from the consolidated profit and loss account, so that the results for the six months will appear as a loss of approximately $5,285,000', they said.

The latter figure given by the directors does not take into account the loss of $2,786,000 on Poseidon shares incurred in the same period. Adjusting for that, the loss for the half-year was $6 million. This is a true measure, indeed a minimum figure, for the share-trading losses actually experienced in a period when claims had been made that a profit rate not greatly less than the previous year's high rate was being maintained. It is a minimal estimate of the half-year's share-trading loss, for two reasons. First, the mining subsidiaries had contributed something positive to the overall result. Secondly, counsel's opinion had evidently found technical reasons for allowing some of the shares shuffled through Hattersley & Maxwell to be treated as sales yielding legal profits to Mineral Securities.

The full extent of the distortions away from normal accountancy standards and concepts of candid reporting which had been introduced into the announcement of a half-yearly profit on 25 January was not less than $9.5 million. That is the difference between a claimed half-yearly profit 'in excess of $5,500,000' and a loss of $6,000,0000

Even these figures may not convey a qualitative aspect of the distortion. The liquidator, Mr Jamison, has supplied us with the list of some 215 stocks and options in which Mineral Securities traded between I July 1970 and 8 February 1971 (Ev. 2984). This corresponds reasonably closely to the period embraced in the statement issued by the board on 25 January 1971, as trading had been very light in the last weeks of the company's operating life. In Mr Jamison's list, the number of stocks on which losses were experienced outnumber those which yielded profits in a ratio of more than two to one. It was not a case of the overall loss incurred in the period being due to some isolated (if big) transactions. The general trend experienced in share trading for the period had been overwhelmingly unprofitable. The half-yearly report and the chairman's earlier speech gave no indication of this. They conveyed a contrary message.

Totality of the Deception

In their report to the shareholders of Mineral

Securities on the enormously successful 1969-70 year, the general managers, Kenneth McMahon & Partners, concluded their review, which was published in the annual accounts, with these words. 'The profit from share trading in 1969-70 has been large, and, conducted as it is in the most speculative end of the share market results can be expected to fluctuate and the year should not be taken as an indication of future share-trading results.'

The warning was sensible and timely. Mr McMahon, as chairman, brought it up Again at the annual meeting a few weeks later. After mentioning the 1969-70 result, he said, as we have noted: 'It may not be possible for the company to maintain that position in the present year ... It would be quite imprudent to forecast the extent of share-trading profits that your company expects to earn in the present year.'

This was disarming. The directors were saying what a hard-headed outside observer might have said, and in doing so they appeared to be showing that they were not carried away by their recent great success and would not hesitate to look a change of fortunes squarely in the eye. After such statements, they would surely not be afraid to acknowledge candidly any onset of adverse conditions. The closing words of the chairman's prepared speech of 24 November 1970 left the feelings of his hearers and readers on that high plane of confidence: 'I and my fellow directors firmly recognise that shareholders own a company, and our efforts are dedicated to giving maximum benefit to you. We have reason to believe that we have a loyal and happy group and that there is a bright future indeed for the company.'

When these words were spoken, Mineral Securities had already backdated the Poseidon loss of $2.8 million which it had incurred early in 1970-71 and had already shuffled the greater part of the six million Robe River shares through Hattersley & Maxwell, both actions having been designed to conceal a heavily adverse turnaround in its current share-trading experience.

When we asked Mr McMahon to explain the concealment by backdating of the loss incurred on Poseidon shares, he said, first, that 'there is a danger in disclosing too much information as regards competitors' (Ev. 1261), and went on to defend the procedure by saying that Mineral Securities had become so much committed to share dealing as a profession that it was inappropriate to report particular instances of profits or losses, even if big. He said: 'If you report one you should report all. I think that it may not be in the best interests of shareholders, who might not fully understand what the company was doing or trying to do' (Ev. 1262).

These arguments are not convincing. Whether there is or is not a significant problem of 'competitors' in share trading getting retrospective information about another trader's dealings, the question at issue in the Poseidon case was not one of revealing the identity of the stock but of truthfully reporting overall financial results of a company for a period, in this case a year. It is also hard to reconcile assurances to shareholders that they owned a company with assumptions expressed elsewhere that they 'might not fully understand what the company was doing or trying to do'. If the shareholders had been informed about this last sentiment of the board at the November annual meeting, instead of being assured about the reality of their proprietorship, they might have begun to regard their directors' statements in a more appropriate light than they could do at that time.

Untenable as such arguments for concealment are when the arguments have to be communicated to others, they express an idea which does not seem unique to the board of Mineral Securities, to the effect that normal standards of veracity do not necessarily always apply in a company's communications to shareholders and creditors, and that in the exigencies of business life, this disingenuousness may be defended in the interests of the shareholders themselves. We are firmly convinced on the contrary, that in an area where great amounts of other people's money is at stake, there is a special responsibility on the part of directors to avoid misleading on basic issues of fact those who will bear the consequences of a company's actions.

On 50 November 1970, Mineral Securities announced an intention to make takeover offers for the outstanding shares in its subsidiaries, Aberfoyle, Cudsen R.Z., and Consolidated Rutile. It offered shares in Mineral Securities as payment in each case. The price of Mineral Securities shares in this period was at or above $10 in the market, being based on incorrect impressions of the company's current profit experience. On 11 December, however, the offer for the shares in one of these companies, Consolidated Rutile, was withdrawn, and a week later the directors of Mineral Securities explained that the 'reason for their withdrawal of the proposed offer for certain shares in Consolidated Rutile Ltd was because it did not appear that unanimity of recommendation by that board would be reached.' Mineral Securities then proceeded on 51 December to make formal offers to Aberfoyle and Cudsen. The 'inside' directors of these two subsidiaries, that is directors common to Mineral Securities and a subsidiary, had conflicting responsibilities. The conflict was made acute by reason of the false impression of the bidding company's current earnings trend that had been conveyed at the annual meeting of 24 November. Mineral Securities was nevertheless proceeding with its share-exchange offers right to the time of its collapse, on the apparent assumption that there would be no lack of unanimity in the recommendations of the boards of the two subsidiaries.

We have now outlined the record of a sustained exercise in the exploitation of the securities market by a corporation dealing in the shares of its listed subsidiary and associated companies: starting with Mineral Securities' use of inside information or knowledge of courses it would pursue from trading in their shares; proceeding to a program for tightening the supply of some subsidiary shares in public circulation to enhance their prices and hence also the market rating and borrowing ability of Mineral Securities; moving on to the preparation of a timetable of public announcements to be made in the future by listed subsidiaries, and to be phased in with the parent company's dealings in their shares; and concluding with the use of a subsidiary's shares in secret transactions with a broker which would give a false impression of the parent company's profit experience. In all the variety of methods employed, there is a continuous program of having the securities market serve the purposes of the company, and the essence of each phase of the extended exercise is the withholding from the market of information that is relevant to the market's evaluating function. In every instance, the existence of an informed market would have made the transaction nugatory. In none of the operations did the implementation of external checks or control - whether from auditors, from member firms of the stock exchange dealing with the company, from the stock exchange or other authorities - restrain the company's pursuit of the program. The exposure of most of the practices (though not of the Robe River transactions) only followed misjudgments by those concerned, leading to the failure of their group.

We turn now to another group of companies of different type which were associated with Mineral Securities and were exploited and badly affected by its policies.

The Minsec Mutual Funds

Early in 1970, Mineral Securities Australia Ltd sponsored and underwrote the launching of two mutual funds to raise money from the public for 'general' investment in the industrial and mineral sections of the securities market. Within a few months, contributions to the two funds exceeded $14 million, including approximately $5 million subscribed by Mineral Securities itself. To people investing in the mutual funds on the basis of information and expressions of policy published in each of their prospectuses, there would have been no obvious reason why the fortunes of the funds should be deeply affected by any turn in the affairs of Mineral Securities, but events proved to be otherwise. The collapse of Mineral Securities early in February 1971 brought an immediate suspension of redemptions for investors in the funds, and losses in excess of $5.5 million on shares which its funds had bought. It was not until 20 months later, in December 1972, that the funds could be re-opened for redemption purposes by their new management. Most of the following discussion of the Minsec mutual funds will be concerned with ways in which the funds had been made to serve the Mineral Securities group's expansionist aims and operations in the share market.

The First Australian Growth and Income Fund opened for subscription in February 1970 and the underwriting period expired late in March. The Second Australian Growth and Income Fund, overlapping the first one, opened for subscription in mid-March and its underwriting period expired at the end of April 1970. Each offered the public shares of 10 cents nominal value at a price of $1 plus service fee, and in each case Mineral Securities Australia Ltd underwrote an issue of five million shares. Each fund had the same board of directors, comprising three directors of Mineral Securities in Messrs McMahon, Nestel and Spooner, and two outside directors, Mr Kenneth John Hedley, an actuary and company director, and Mr Alan Maxwell Fisher, a company director. Mr McMahon was the chairman of both mutual funds. The first fund was substantially over-subscribed, and by 30 June 1970 had obtained more than $9,570,000, of which Mineral Securities subscribed $1 million. The second fund experienced a shortfall in public subscriptions, and of the $4,707,00o held at 30 June 1970, Mineral Securities, as the underwriter, had provided about half; later public subscriptions reduced the Mineral Securities proportion somewhat.

Each of the funds was incorporated in New South Wales as an unlimited company, meaning that the personal liability of shareholders to contribute in respect of any debts incurred by the funds would not be restricted to the amount of any unpaid capital on the shares they had taken. This has been a characteristic of other mutual funds; their unlimited liability permits the redemption of existing shares without the delays involved in obtaining court confirmation of a special resolution for reduction of share capital which is required when limited-liability companies propose similar action. It may be questioned whether this characteristic of Australian mutual funds, which is relatively unknown to inexpert investors and scarcely encountered anywhere except in mutual funds, was sufficiently publicised in the prospectuses of these two funds, though they were very much superior in this regard to the mutual funds sponsored by the Trendex group of companies to which we refer elsewhere. The unlimited liability of shareholders in the Minsec funds was stated on page 17 of the first fund's prospectus and page 15 of the second fund's prospectus under a heading, 'Nature of the Fund', where it was also said that in order to protect shareholders against this liability, one of the funds' articles of association restricted 'the amount for the time being remaining undischarged on all monies borrowed by the Fund to 25 per cent of the net tangible assets of the Fund'. A reader was then referred to the back of the prospectus for the full text of this article which was to safeguard investors against high borrowing commitments by the fund. Unlike the summary account given in the body of each prospectus, the text of the article allowed an exemption from the borrowing restriction of 'liabilities in respect of the purchase price of any securities or investments whatsoever purchased or contracted to be purchased or acquired by the Company'. We believe that the exemption we have quoted could have been capable of wide interpretation, and might have allowed the funds to incur extensive liabilities, putting the shareholders personally at risk. We do not suggest that the loophole was used, but that the potential existed for its use. The crisis which overtook the Minsec mutual funds in February 1971, and the substantial capital losses experienced by shareholders in the funds, did not involve them in any obligations to meet additional liabilities of the funds, such as did occur in the case of one of the mutual funds sponsored by the Trendex group.

It is to be noted that the Minsec funds, in their group capacity, like their sponsor Mineral Securities Australia Ltd, relied heavily at times on credit from brokers. Thus, on 50 June 1970 the consolidated accounts of the First and the Second Australian Growth and Income Funds showed a total of $5,428,704 as being owed to brokers. Such debts would evidently have enjoyed exemption from calculations restraining the borrowing power of the mutual funds in the words of the articles of association which we have quoted, and the exemption may well have extended beyond such debts to brokers in respect of shares purchased. In fact, however, the larger part of the $5,428,704 owed to brokers at that date was not incurred by the funds themselves but by their wholly owned subsidiary 'trading' companies, called respectively First EFA Traders Pty Ltd and Second EFA Traders Pty Ltd. From the viewpoint of shareholders in each of the Minsec mutual funds, the advantage of this arrangement was that most of the debts to brokers had been incurred by subsidiaries which were limited liability companies (unlike the funds), so that the liability of the funds' shareholders in respect of these debts stopped with the paid-up capital that the funds subscribed to the subsidiaries. From the viewpoint of brokers, had they been aware of it, the position was strikingly different, for the actively speculating subsidiary companies of the Minsec mutual funds, while owing brokers millions of dollars, had a paid capital of exactly one dollar. We shall refer again later to the subsidiaries' overall gearing of shareholder funds to liabilities.

The idea that Mineral Securities should establish one or more mutual funds originated outside the group with two men, Mr Christopher Soren Shann Turnbull and Mr Ananda Krishnan Tatparandandam, both graduates of the University of Melbourne and of the Harvard Business School, who had formed a consultancy business, Turnbull Krishnan & Co. Pty Ltd. The Turnbull Krishnan company was one of an elaborate structure of companies surrounding the mutual funds on their formation. The initial role of Turnbull Krishnan, which was soon to be diminished (see Ev. 1369; also reflected in modifications appearing in the second prospectus issued by Second Australian Growth and Income Fund in September 1970), consisted, first, in 'selling the funds' to the public and secondly offering investment advice to the funds in relation to industrial, as distinct from mining securities.

The flotilla of attendant companies around the mutual funds begins with the 'Fund Management Company', which was called Equity Funds of Australia Ltd. In the early prospectuses of the funds (p. 12), this company was given the simultaneous character of being 'a subsidiary of Mineral Securities Australia Limited and also a joint venture between Kenneth McMahon & Partners Pty Ltd and Turnbull Krishnan & Co. Pty Ltd'. The original directors of Equity Funds of Australia Ltd were Messrs Spooner (chairman), McMahon, Nestel, Krishnan and Turnbull.

A second attendant to the Minsec mutual funds had the designated function of 'Investment Advisors to the Management Company'. This was a company called E.F.A. Advisers Pty Ltd. The official returns show that it had a paid capital of $100, of which a majority ($69) was held by Kenneth McMahon and Partners, with Turnbull Krishnan and Co. holding $29 and Messrs T.A. Nestel and G.J. Davis each $1. Mr Spooner was one of the two directors of E.F.A. Advisers. The other was Mr Alan Surrey Bogg, an employee of Kenneth McMahon & Partners, and being second to Mr Nestel in that company's Investment and Trading Division.

Thirdly came the 'Consultants to the Management Company', a title held at first by Turnbull Krishnan & Co. Pty Ltd and later bestowed on Kenneth McMahon & Partners Pty Ltd. As we have previously noted, all the capital of Kenneth McMahon & Partners was held by Mr McMahon's family.

Next in the list of associated companies were the 'Fund Distributors', a role occupied by a company called E.F.A. Distributors Pty Ltd. Its capital of $2 was shared equally between Mr Turnbull and the company Turnbull Krishnan Pty Ltd. The directors of E.F.A. Distributors were Mr Spooner, Mr G.J. Davis, Mr M.Y. Polany, Mr N.D. Wright and Mrs Ananda Krishnan Tatparandandam.

Every one of these attendant companies to the mutual funds had the same address as that of Kenneth McMahon and Partners, namely 291 George Street, Sydney. The registered offices of the funds themselves were care of A.H. Dickins & Co., chartered accountants, on the 9th floor of 291 George Street. This was also the registered office of Mineral Securities Australia Ltdo Mr Spooner indicated in evidence (Ev. 1854), that some of the attendant companies had no employees of their own but 'used the investment staff of McMahon & Partners' as he expressed it. In this regard, the companies again resembled Mineral Securities.

In our opinion, the prospectuses for the Minsec mutual funds did not convey to readers the extent of the influence which was to be exercised by Kenneth McMahon & Partners Pty Ltd. The following passages are extracted from the section of their launching prospectuses headed 'Investment Policy', where the phrasing was almost identical for the first and second funds:

The Fund will be of a 'general' investment type, limiting itself to neither industrial equities nor mining stocks so that investors may participate in superior investment opportunities arising from any sector of Australia's growth and development.

The objective will be to obtain consistent long term above-average performance of both capital appreciation and income ...

Mineral Securities Australia Limited has now substantially reduced its long term investments in companies in which it does not have management control and has become a mining house with 13 listed subsidiaries. It is intended that the Fund will direct its activities to long-term portfolio investment not associated with management control and extended to include securities of Australian public companies outside the mining sector.

While the Fund has a basic long term performance objective, the Australian market offers many short term profit-making opportunities through, First/ Second E.F.A. Traders Pty Ltd., a wholly owned subsidiary of the Fund, to supplement the distributions of the Fund. It is hoped that short-term profit-taking operations will more than cover the operating expenses of the Fund.

We believe that the first three paragraphs quoted convey an impression that the investments to be made by the mutual funds would generally be in stocks from which Mineral Securities itself was and intended to remain at arm's length, stocks in which Mineral Securities was not concerned to gain a dominant or major interest. We shall shortly examine the subsequent record of the funds to compare them with that impression. Meanwhile, the final paragraph of our quotation from the prospectuses, while indicating that the funds would engage in short-term share trading, did not reveal some circumstances relating to these speculative activities, including the fact that Kenneth McMahon and Partners, a company whose name did not appear in the extensive list of companies shown in the launching prospectus as ministering to the First Australian Growth and Income Fund, 'had absolute discretion as to buying and selling' (Ev. 1854) of all shares by the subsidiary First and Second E.F.A. Traders Pty Ltd, subject to limitations placed on the total amounts committed to this speculative trading. Unknown to shareholders of the funds, moreover, the quantitative limits on the proportion of their assets which could be committed to such speculation was revised upwards in the first few months of the funds' existence. 'Originally in the funds', Mr Spooner said, 'the board determined that not more than 10 per cent of total assets should be used for share trading. I think this was increased to 15 per cent, but within that limit McMahon and Partners were autonomous' (Ev. 1854).

The influence of the Kenneth McMahon & Partners Mineral Securities team extended beyond the short-term trading activities of the funds. The 'long-term investment' policies of the funds proved to be markedly different from what a reader of the prospectus would have expected, for in both mutual funds the managers concentrated the greater part of their long-term investments in shares of Mineral Securities itself and other companies which were either subsidiaries of Mineral Securities or associated with it and with its expansive ambitions. This policy could hardly have been conceived after the preparation of the prospectuses, for it began to take effect from the time of flotation. For instance, public subscriptions had only just been received in response to the prospectus of the First Australian Growth and Income Fund when investments were made in the shares of Mineral Securities and two of its subsidiaries, Aberfoyle and Cudgen. By the end of April 1970, one month after the underwriting period has expired, about $1.4 million of the $9.6 million raised in the float had been spent in buying shares of Mineral Securities: buying shares, that is, in the company which was the main promoter and sole underwriter of the fund and the principal shareholder in the fund's management company, and a company under the general management of Mr McMahon's proprietary company which had absolute autonomy in the fund's short-term investment policy. A similar early buying of Mineral Securities shares took place in the Second Australian Growth and Income Fund.

The first published accounts of the two mutual funds, for the period ending 30 June 1973, were issued at the end of July, showing the quantities of the various shares held in the investment sections of the funds, and stating that the directors followed a policy of retaining substantial liquid funds in the expectation of making more profitable investments later. Subsequently, the funds issued quarterly statements for the periods to 30 September and 31 December, giving the cost and market values as well as quantities of each stock held for long-term investment. It is thus possible to trace the course of the funds' investments in Mineral Securities Australia Ltd and associated companies, and the Committee has also inspected records of the two trading subsidiaries for this period. As we have noted in an earlier section of this chapter, the mutual funds' next major bout of purchasing Mineral Securities shares came in the period from late September to late October 1970. This was the time when Mr Nestel and his colleagues in Kenneth McMahon and Partners were exercising themselves with the preparation of an 'Acquisition Time Table' and a 'Group Philosophy' for Mineral Securities, and posing the questions: 'Who will buy group coys during currency of bids? Who will buy MSAL up to Dec 1 to ensure that MSAL/group relation price wise is reasonably maintained?'

Having spent more than $1.3 million on additional Mineral Securities shares in the five weeks to the end of October, the first and second mutual funds by 51 December 1970 had respectively committed 60 per cent and 56 per cent of their long-term investment to companies in the Minsec group or companies over which Mineral Securities was planning to obtain control in conjunction with Castlereagh Securities Ltd in the partnership to be known as Power and Resources of Australia Ltd. By far the largest single investment of each fund was in Mineral Securities itself (Table 14-5).

TABLE 14-5

SHARE INVESTMENTS OF MINSEC MUTUAL FUNDS, 31 DECEMBER 1970

	First Australian Growth and Income Fund	Second Australian Growth and Income Fund
	(cost)	(cost)
Companies within Minsec group:		
Mineral Securities Australia	1,799,340	998,691
Aberfoyle	96,816	-
Cudgen R.Z.	86,628	-
Robe River	110,000	50,000
Companies to be acquired by Power and Resources of Australia:		
Kathleen Investments	641,428	324,091
Thiess Holdings	358,844	185,851
Other share investments *	2,065,299	1,243,026
Total	5,158,355	2,801,659

* *Excluding shares held for trading*

The 'other share investments' shown in Table 14-5 included substantial holdings in Direct Acceptance Corporation Ltd (at cost of $499,991 to the first fund and $377,377 to the second). Each fund had bought the shares shortly after flotation, when the chairman of Direct Acceptance, Mr Turnbull, was a director of the first fund's management company and a principal of Turnbull Krishnan, the 'consultants to the management company'. These investments also were reported to shareholders in the accounts for 50 June 1970.

Generally speaking, the investment activities of the funds were largely arranged to fit in as two more units of the group for purposes of Minsec's strategy of corporate deployment in the securities market. The mutual funds could simultaneously be used to support operations of the master-company of the group and be put in a position to expect profits from picking up shares in advance of some Minsec announcements and company moves. Thus the first fund had bought shares in the partly owned Minsec subsidiaries, Aberfoyle, Cudgen and Consolidated Rutile, in October 1970, before Mineral Securities made bids for the remainder of those shares at the end of November. Again, the funds had bought shares in Kathleen Investments in September and shares in Thiess in December-January, while Mineral Securities had become engaged in negotiations to gain control of those companies. As another example, the mutual funds made purchases of Robe River shares in September and October 1970, when, as we have noted, Mineral Securities and Kenneth McMahon and Partners had privileged information on the upgrading of the Robe River project.

In addition, the short-term trading conducted by the funds' wholly owned subsidiaries included dealings in shares of the Minsec group. Our inquiries show that this became an increasing part of the subsidiaries' role in the later months of 1970. They traded in shares of Mineral Securities, Aberfoyle, Cudgen, Consolidated Rutile, Robe River, Kathleen Investments and Thiess, their operations being mainly financed by brokers' short-term credit.

We have investigated in some detail the records of the bigger of these subsidiaries, First E.F.A. Traders Pty Ltd. The life of this company divides into two parts: a highly profitable period to I September 1970 and a less successful period after that date. Its share purchases got strongly under way in June, and by the end of that month it had bought 58 oil and mining stocks and seven industrial stocks for a total cost of $2,566,000. The list is generally one of relatively obscure mineral stocks whose market prices might be susceptible to change. By the same date, 50 June, the speculative purchases by the sister company, Second E.F.A. Traders Pty Ltd were barely half as much as those of First E.F.A. Traders. The combined entry of the two mutual-fund subsidiaries into the speculative area of the share market in May~June 1970 appears to have had substantial effect in helping temporarily to lift prices to levels suitable for quick turnover profits, though market conditions generally were becoming increasingly difficult in the circumstances of credit tightness which developed in that winter.

The balance sheet of First E.F.A. Traders at 50 June shows how, with a paid capital of one dollar and shareholder funds of $10,545, representing one-six hundred and seventieth part of its assets, the company's share purchases had been mainly financed to this point by brokers (Table 14-6). A large advance of $5 million received from the holding company (First Australian Growth and Income Fund) is shown as being almost entirely offset by 'deposits and cash', but that item will be explained and discussed a little later in this chapter.

TABLE 14-6

FIRST E.F.A. TRADERS PTY LTD, BALANCE SHEET, 30 JUNE 1970

<u>Share Capital and Reserve</u>				
Issued capital	1			
Unappropriated profits	10,542			$10,543
<u>Assets</u>				
Deposits and cash (including interest accrued)		4,753,484		
Shares held for trading		2,250,458		
Shares held for investment		121,528		
Loan (unsecured)		5,000	7,110,450	
<u>Financed by</u>				
Owing to Holding Company		5,006,457		
Owing to brokers	2,243,152			
(Less due from brokers)	150,292	2,092,860		
Other		590	7,099,907	
				$10,543

The shares which First E.F.A. Traders had bought by the end of June were nearly all turned over in the next two months, yielding brokers commissions in return for their credit and enabling First E.F.A. Traders to transfer profits of $568,000 to its journal for July and August. Thereafter, its trading volumes and earnings were more subdued, as Table 14-7 shows.

TABLE 14-7

FIRST E.F.A. TRADERS PTY LTD, MONTHLY SALES AND PURCHASES OF SHARES

	$'000s			
	Market value of portfolio at end of month	Sales	Purchases	Sharetrading income transferred
1970				
June	2,271	198	2,566	18
July		1,511	335	303
August		428	59	265
September		71	910	-1
October		47	404	-13
November			60	
December		85	88	28
1971				
January	1,174	88	22	3
February	1,041	75	2	43

In this period, First E.F.A. Traders engaged in some short-selling operations and options trading, though not on a heavy scale, according to the records. On the whole, both classes of transaction brought it more losses than profits.

The reduction in the company's pace of market turnover in the later months of 1970 was not only a symptom of changed market conditions but also appears to have been the result of a policy of concentrating much more of First E.F.A. Trader's purchases in shares that were involved in the expansion program of Mineral Securities. In supporting that company's operations and the market for Mineral Securities itself, there was less scope for re-selling of stocks bought than there had been before. The new element of 'Minsec stock' purchases is shown in Table 14-8.

TABLE 14-8

PURCHASES BY FIRST E.F.A. TRADERS PTY LTD OF SHARES IN THE MINSEC GROUP OR THE MINSEC STRATEGIC PROGRAM, SEPTEMBER 1970 TO JANUARY 1971

	Sept.	Oct.	Nov.	Dec.	Jan.
Stock bought:					
Kathleen Investments	216,093	-	-	17,040	-
Mineral Securities	-	93,154	24,007	-	-
Queensland Mines	195,110	-	-	-	-
Robe River	117,632	210,265	-	-	-
$528,855	$503,419	$24,007	$17,040	-	
$910,000	$404,000	$60,000	$88,000	$22,000	
58 p.c.	75 p.c.	40 p.c.	19 p.c.	nil	

What we have said about the 'investment' activities of the First and the Second Australian Growth and Income Funds being made to serve the ends of Minsee-McMahon and Partners strategy therefore applied also in considerable measure to the 'trading' side of the mutual funds' business. The Committee invited Mr Spooner, as the chairman of the management company, Equity Funds of Australia, to describe the way in which the boards of the funds and the attendant companies arrived at investment recommendations and decisions. Mr Spooner said:

You may be aware that there was a company called ETA Advisers which was the investment limb of Equity Funds of Australia. ETA had no employees but it again used the investments staff of McMahon and Partners so that the mining or industrial analysts of McMahon and Partners would supply a recommendation on a certain company and through ETA Advisers it would go to Equity Funds of Australia. The directors of Equity Funds of

Australia would consider the recommendation with a view to deciding whether they would in turn recommend it to the board of the fund. I am sure there were several instances, although I cannot be specific, where the directors of Equity Funds of Australia said that a particular recommendation should not go to the fund board at least at that stage, so they did, as it were, screen recommendations. But the recommendations were eventually made to the board of the fund, which included two independent directors, so that no long term investment was made without the approval of the fund board both as to the company and as to the amount to be invested. So far as trading was concerned, the funds followed the precedent which existed in Mineral Securities and that is that McMahon and Partners had absolute discretion as to buying and selling, except that in the funds there were limits placed on the total amount which could be invested in trading. Originally in the funds the board determined that not more than ten per cent of total assets should be used for share trading. I think this was increased to 15 per cent but within that limit McMahon and Partners were autonomous.

(Ev. 1854)

The evidence of Mr Spooner and other witnesses indicates to us that~ while the board of directors which was common to both mutual funds, including the two 'outside' directors~ undoubtedly had the power of veto over recommendations emanating essentially from the office of Kenneth McMahon & Partners, the initiatives rested overwhelmingly with that office (exclusively so in the case of speculative trading), and the record of the funds' dealings~ such as we have outlined~ confirms that impression.

The main consequence from the creation of these mutual funds, apart from furthering the pursuits of the Minsec group and encouraging them to believe they had the means for expanding their ambitions, was to put still more eggs of public investment in the same few baskets favoured by the cadre of investment analysts in Kenneth McMahon & Partners. Behind an array of apparently distinct functional companies associated with the mutual funds, and as in the investment policies of member companies of the Minsec group, there was a lack of effectively diverse opinion and different initiatives. Directors of the funds had proclaimed in each prospectus that: 'Diversification of investment is a well recognised principle of investment management.' Once again, their penchant for enunciating sound principles gave ordinary investors a fatal impression that the directors would be upholding the principles.

'Back-to-Back' Lending

Besides subordinating the investment policies of the mutual funds to the purposes of Mineral Securities, the senior directors of that company bent other implicit or explicit standards in their dealings with the funds of which also they were directors. In examining these dealings the Committee found some striking examples of the exploitation of what is called the 'back-to-back' lending technique. This practice had particular application while the mutual funds were liquid in the early months. Unknown to shareholders, the principal borrower on short term from each of the funds in that period was Mineral Securities itself, adding again to its repertory of roles in relation to the funds. On the surface, however, the sense of propriety which in this case forbids financial inbreeding and concentration of risk was again observed. The board of the mutual funds had a select list of approved borrowers to whom lending should be made, and the name of Mineral Securities did not appear on the list. Instead, those responsible found an intermediary party willing to fill out the ritual: the funds lent large amounts to the intermediary on the understanding that the intermediary would immediately transmit the money on loan to Mineral Securities. To be precise, each fund (parent, unlimited liability company) lent to its subsidiary proprietary company, and the subsidiary passed on much of the money to intermediaries for back-to-back lending to Mineral Securities. Our inquiries revealed the identities of two parties which acted as intermediary from time to time, and the list available to us may not be complete. It seems likely that the most active player of the intermediary role was the company King & Yuill Investments Pty Ltd, which is associated with the Sydney broking firm of Ralph W. King & Yuill. The combined back-to-back loans from the two funds passing through King & Yuill Investments to Mineral Securities reached a peak of $7.8 million in mid-June 1970, on the evidence available. It declined to about $1.1 million in early September and was almost extinguished by the end of December. We were told that another intermediary for back-to-back lending to Mineral Securities from the mutual funds was the merchant banking firm of Ord-BT Co. Ltd (Ev. 2987). And in back-to-back dealings between Mineral Securities and Robe River another merchant banking company to be involved was Westralian International Ltd (Ev. 2986). This latter company, unlike the other two merchant banks mentioned, had no broker associations; of its eight shareholders, three were Australian (MLC Assurance Co. Ltd; and the Rural and Industrial Bank of Western Australia; and Western Underwriters Pty Ltd) and five were overseas (The Crown Agents, Alexanders Discount Ltd and F.D. Sassoon & Co. all of London; Credit Lyonnais of Paris and Continental Illinois National Bank & Trust Co., of Chicago).

We found elsewhere in our study of Mineral Securities' affairs that it obtained large back-to-back loans (concealed credit) from the public listed company, Robe River Ltd, over which it had control. With King & Yuill Investments again acting as dummy, Robe River lent as much as $8 million to Mineral Securities early in September 1970, and big loans of this disguised nature from Robe River's resources persisted in the subsequent months while Mineral Securities was buying up large amounts of Robe River shares, partly on the basis of inside information. Thus, by 30 November, a few days after Mr McMahon told Mineral Securities shareholders that their company had acquired a majority of Robe River's shares, the records show Robe River's back-to-back lending to Mineral Securities as standing at $4,000,000. (A week earlier it had been $3.5 million; a week later it was $5.8 million). A knowledge of the financial condition in which Mineral Securities then stood leaves no room for doubt that the loans obtained surreptitiously from Robe River helped materially to finance the process by which Robe River became a subsidiary of Mineral Securities, or that Robe River was being placed at risk in making such loans to Mineral Securities at the time. Its balance of back-to-back lending to Mineral Securities still stood at $3 million at the end of January 1971 when the concealed borrower was on the point of collapse.

None of the witnesses from the Mineral Securities board with whom we raised the subject of the back-to-back lending operations sought to explain the practice in terms which could make us consider that it had any commercial function other than for purposes of subterfuge. On the subject of the operations involving Robe River Ltd, Mr Geoffrey David Applegate, who provided legal advice to Mr Jamison in the liquidation process of Mineral Securities, told the Committee (Ev. 2986):

As I understand it, the purpose of the back-to-back transactions was to arrange finance for Mineral Securities from Robe River Ltd without Robe River Ltd being in breach of its trust deed by lending in excess of a certain amount to associated companies.

Two directors of Robe River, Messrs McMahon and Nestel, presumably knew about and either sanctioned or initiated the concealed loans from that company to Mineral Securities, being the senior directors and executives of the recipient company. They no less certainly bore responsibility for the concealed loans made by the First and the Second Australian Growth and Income Funds to Mineral Securities, for they were the senior directors of both the lender and the borrower. They held simultaneous roles which, while involving potential direct conflicts of responsibility, also provided peculiar scope for privacy in the arrangement of inter-company transactions. The scope for privacy offered special temptation.

Another example of back-to-back lending was the loan by Mr Nestel of his own funds to King & Yuill Investments Pty Ltd which was then passed on to Minsec. On 2 February 1971, King & Yuill Investments withdrew $120,000 from Minsec and, that same day, repaid it to Mr Nestel. We shall shortly be discussing the liquidity crisis faced by Minsec on 2 February and how, the following day, Minsec's shares were suspended from trading on the stock exchanges.

The whole history of Mineral Securities illustrates on the corporate level, irreconcilable conflicts emerging from the multiple roles of directors, corresponding to the conflicts which we have noted elsewhere in this report, arising from the multiple roles of brokers, counsellors, merchant bankers and other intermediaries in the securities market. Having responsibilities to various groups of investors, the Minsec directors subordinated some groups' interests to others without the knowledge of the parties concerned. Among those whose interests were subordinated were the shareholders of the mutual funds, and the most emphatic instance of this was to come at the very death of Mineral Securities when that company gained privileged advantage in the redemption for cash of its shareholdings in the mutual funds to the loss of ordinary investors in the funds.

The Final Redemption

It will be recalled that Mineral Securities took up one million shares in the First Australian Growth and Income Fund, representing nearly 10 per cent of that fund's capital and premium reserves, and also took up more than two million shares in the Second Australian Growth Fund, or more than forty per cent of its ultimate capital and reserves. By a reverse process, the two funds invested much more money in shares of Mineral Securities than in any other company, these shares representing (at cost) about 20 per cent of the total assets of each fund. No publicity had been given to the fact that Mineral Securities held large parcels of shares in the funds; hence the possibility that a conflict could develop in time of crisis was completely unknown to ordinary investors in the funds.

In the first few days of February 1971, the directors of Mineral Securities were confronted with a critical liquidity problem, compounded by rising doubt about the tenability of the half-yearly profit statement they had released to the public in the previous week. On 2 February, according to Mr McMahon's testimony, the directors who were in Sydney visited the offices of the merchant bank, Ord-BT where a number of creditors and bankers were assembled for the purpose of arranging longer-term loans for Mineral Securities, and the directors immediately announced that the previously reported profit of $5.5 million was in fact a loss of more than $5 million. Mr McMahon said this had the effects of voiding an underwriting agreement for a proposed preference share issue and destroying the confidence of every member of the lending group in the company. On the afternoon of the next day, 5 February, Mineral Securities delivered a letter to the Stock Exchange seeking a suspension of trading in its shares. On the following morning, 4 February, Mr McMahon gave a public statement on the corrected profit position to the Stock

Exchange, and asked for the suspension of trading in the associated companies (Ev. 1192).

The Committee has documentary evidence showing that, meanwhile, on 2 February the ANZ Nominees, acting on behalf of Mineral Securities, wrote formally to the two mutual funds requesting the redemption for cash of all the shares held by Mineral Securities in the funds. Between 9.50 and 9.40 a.mo the next day, 5 February, two members of the 'Share Committees' of the funds, Mr Spooner and Mr Swift, who was the secretary of both funds, met and agreed to redeem Mineral Securities' one million shares in the first fund and 2,219,780 of its shares in the second fund; another 280,220 shares in the second fund were not redeemed because the fund did not have sufficient cash at the time (Ev. 1872-77). Payments by cheque of $850,000 from the first fund and $2,020,000 from the second were made instantly at the meeting between Messrs Spooner and Swift, and Mineral Securities banked the cheques within a few hours. The amounts of the payments totalling $3 million were based on valuations of the fund shares, which were in turn determined by market prices of the funds' investments ruling before 3 February (actually on prices as at 28 or 29 January, according to documents obtained by the Committee and Mr Spooner, Ev. 1875).

Both Mr Spooner and Mr Swift were directors of Mineral Securities, and two of the other directors of the mutual funds, Messrs McMahon and Nestel, also were directors of Mineral Securities. All the directors of Mineral Securities and a majority of the directors and principal executives of the mutual funds knew for a certainty on the day before the redemptions that: (a) Mineral Securities' recently announced big profit was spurious and had been corrected to a heavy loss; (b) having already been facing liquidity problems, Mineral Securities had now~ in the words of its chairman, lost 'the confidence of every member of the lending group with which it had been negotiating, and (c) the proposed preference group share issue was voided. These devastating developments had a grave bearing on the worth of Mineral Securities' shares, and hence on the value of the funds which had invested heavily in those shares. As events were to show, the developments had made the shares worthless. But at the time of the redemption, the public had no inkling of these facts, and the market price of Mineral Securities shares was not affected by them. The market was misinformed about the profit and uninformed as to the liquidity crisis. The last stock exchange price, so heavily influenced by previous Minsec - induced market activities in less abnormal circumstances, was no longer pertinent to the making of an informed valuation of the Mineral Securities shares and their bearing on the policies of the mutual funds, and the funds' own directors were in a unique position to make such an informed judgment when nobody else could do so.

Nevertheless, Mineral Securities' holdings in the mutual funds were redeemed on the basis of the huge over-valuation, and the transaction was speedily completed within a few hours of the formal request for redemption being received. The company which had been responsible for seriously and lastingly damaging the finances of the funds was the one shareholder in the funds to be given exemption from bearing a share of the consequences. This was at the direct expense of other innocent and helpless investors in the funds, for the automatic effect of the redemptions was to reduce the equity of the remaining investors: all of the impending capital losses arising from the necessity to write off or write down the value of investments chosen by the managers would have to be borne by the remaining investors instead of being shared with the largest subscriber to each fund, Mineral Securities. The effects were especially severe in the case of the Second Australian Growth and Income Fund; the narrowed concentration of the distribution of the losses after the cash payment of $2,020,000 to Mineral Securities in itself cost the remaining'investors nearly one-quarter of their original investment, additional to the loss of about another quarter which they would have had to suffer in circumstances of a full distribution of the capital write-offs among all subscribers. In consequence of the doubled load, the net asset backing of the remaining shares in this fund was reduced from $1.05 on 50 June 1970 to 47 cents on 50 June 1971 (Directors' Report, Second Australian Growth and Income Fund annual report 1971). Over the same period the asset backing of shares in the First Australian Growth and Income Fund was reduced from 99 cents to 66 cents (Directors' Report, 1971). Because of difficulties in valuing or selling other investments of the two funds, especially in Robe River, the new managers were unable to re-open them for redemptions by the public shareholders until December 1972. That was nearly two years after the redemption of the Minsec holdings.

As an illustration of calculated arbitrariness in the decision to redeem Mineral Securities' holdings, the Committee received evidence from a shareholder in the First Australian Growth and Income Fund, Mrs N.A. Jeffrey, of Malvern, Victoria, to the effect that she applied to that fund by registered letter on 29 January 1971, requesting redemption of her 6,000 shares. This was done without any knowledge that difficulties were confronting Mineral Securities and the fund. The fund received and processed her application on 2 February, the day when ANZ Nominees wrote on behalf of Mineral Securities and a day before that application was received. But whereas Mineral Securities' three million shares in the funds were redeemed, Mrs Jeffrey's six thousand were not. Documents supplied to us by Mrs Jeffrey, and the testimony of her husband, Mr M.S. Jeffrey, who represented her in the hearings (Ev. 1329-52), have confirmed the circumstances as she reported them to us. While it would obviously have been wrong even on 2 February 1971, the day before the

Minsec redemption, to have made redemption payments based on the prevailing stock exchange price of Mineral Securities shares, we have no doubt that, in any payments which were to be made, Mrs Jeffrey's application was entitled to priority in time over that of Mineral Securities.

On the afternoon of 3 February, after making the payments of $3 million to Mineral Securities, the directors of the funds held a meeting at which Messrs McMahon and Nestel were not present. By that time Mr Spooner could record that he had advised the other members of the board, Messrs A.M. Fisher and K.J. Hedley, 'that because of a liquidity problem' Mineral Securities had redeemed its holdings. This is the first reference made in the minutes of the directors' meeting to the problems facing Mineral Securities, even though Clause 2(e) of the management agreement between the second mutual fund and Equity Funds of Australia Ltd, the manager, provided that the manager should:

Promptly notify the fund of any fact coming to the Manager's notice or of any assessment or judgment by the Manager which may materially affect the worth of any substantial amount of the Fund's investments or which may call for special consideration by the Board of Directors of the Fund in relation to realising reducing or increasing the same.

On paper, this unequivocally expressed clause of an agreement drawn up with an obvious air of binding each party would seem to offer fund shareholders watertight assurance that whenever the management company discerned changes in the prospect for any significant investment of the fund, they would instantly as a matter of duty, quickly alert the fund's board of directors and would so bring the matter squarely into the arena of active consideration and discussion from the fund's viewpoint. In practice, however, a majority of the directors of the management company, Equity Funds of Australia, being the three most senior of them, were also a majority of the board of the mutual fund - meaning that they would see no particular need to go through the motions of informing themselves - and were yet again a majority of the board of the company which represented the funds' most 'substantial' investment - meaning that they could be inhibited in one capacity from reporting realistically and critically on circumstances arising out of actions and decisions they had deliberately taken in another capacity. In such circumstances of conflicting personal responsibilities, an agreement purporting to set up an early warning system for the protection of fund shareholders was hollow verbiage, but dangerous verbiage because of the impression it was likely to, and meant to, convey to an inexpert class of investors.

The responses given by directors of Mineral Securities who appeared before the Committee as witnesses when they were invite~ to comment on or explain the events of the Minsec fund redemptions are probably best summarised from the evidence of Mr Spooner (Ev. 1872-83). In the course of this account, he said that the decision to redeem the three million shares held in the mutual funds had been reached on 29 January at a board meeting of Mineral Securities where 'it was agreed that the funds would be redeemed, and I was asked to execute this on behalf of the management company' (Ev. 1873). This was because of Mineral Securities' liquidity problems, but the directors did not then think the company's position was as grave as later events proved it to be (Ev. 1874). 'I would like to emphasise the terrible speed of events that unfolded in those two or three days,' he said. The decision on 3 February 1971 to seek a suspension of stock exchange trading in Mineral Securities shares came after the redemption of the fund holdings on the same day, when discussions with the merchant bankers Ord-BT showed a deterioration of the outlook (Ev. 1876-77). Mineral Securities was in a very serious short-term position but it was not insolvent (Ev. 1876 & 1879). The funds 'were so bound up with Mineral Securities and so dependent on it because of their investment that I believe it was very much in the interest of the funds that thisredemption should proceed to allow it to assist Mineral Securities to get out of its difficulties' (Ev. 1874). Regarding the withdrawal and reversal of the Mineral Securities half-yearly profit, which was known to be impending as a public statement at the time of the fund redemptions, Mr Spooner said: 'Perhaps I was naive, but I certainly did not expect that the withdrawal of it would have the effect that it did have' (Ev. 1881). (After Mr McM~lon had given evidence on the redemption of Minsec's holdings in the mutual funds, he submitted an affidavit correcting certain statements he made in his testimony. This affidavit is produced as Committee Document 14-4). In view of the existence of other inquiries into the failure of Mineral Securities and its associated companies, we will limit our comment on the fund redemptions to the questions of principle raised by the directors' evidence. First it demonstrates yet again the frequent incompatibility of multiple personal roles in the companies and the mutual funds. It must be observed that the explanations of the fund redemptions given by the directors are couched in terms of the pressures and crisis atmosphere existing in Mineral Securities. This was the consideration tending to drive others from their minds. 'It was agreed' - that is, agreed at a board meeting of Mineral Securities, and nowhere else - 'that the funds would be redeemed ...' The sense of urgent haste was in the interests of Mineral Securities, though it was only one party in the transactions, and in the haste the redemption price of the fund shares to this favoured holder was not adjusted to take account for that holder's own drastically changed circumstances. The benefit of the doubt was given to the company's chances of pulling out of its difficulties, not to the prudent attitude to be adopted on behalf of fund investors which would be taken by unequivocally committed representatives of fund investors. Though the payment of $3 million cash on the redemptions did not prevent or delay the total loss of the funds' investments in Mineral Securities, the sending of good money after bad continues to be rationalised as having been 'very much in the interests of the funds'. Rosy ideas were allowed to be entertained concerning the calamitous financial condition of Mineral Securities, a condition which is to be observed in rather more detail shortly, and about the possibility of a mild reaction among creditors and in the stock market to the news of an adverse adjustment of $6.8 million to a half-yearly profit statement issued a week previously, despite the insight this gave into some extraordinary devices which had been practised to arrange an appearance of earned profits and despite the bearing that such a reversal would have on the company's general credibility.

Into the Short-Term Money Markets

The 'Investment and Trading Department' of Kenneth McMahon & Partners Pty Ltd incorporated all the share market experts (about eight) and all the money market experts (one or two) of that private company, and therefore of the entire Mineral Securities group of public companies. The combination of the share-market and money market activities in a compact unit of the control room for the group seems to be part of the reason why the biggest share speculating company in Australian history became unobtrusively the biggest borrower from the short-term money markets, and after that became a still bigger share trader. This development took place in four months, August to December 1970, when Mineral Securities drew more than $50 million out of the money markets without people in those markets appearing to be aware of the scale of its borrowings, and put the money into mining shares on the stock exchanges. Mineral Securities had already acquired some fairly delicate problems for negotiation in a falling share market before late August, when its borrowings in the money market were still negligible. The subsequent effortless process of a four months' heavy excursion into those markets sealed its doom and placed pressures on the money markets that repay a deal of attention.

For a substantial part of the four months, the directors of Mineral Securities knew that the share market had become inimical to short-term trading. The managing director's report to the board for the December 1970 quarter said that Mineral Securities and its relevant subsidiaries 'did virtually no share trading during the month of December except to sell small quantities of trading stock. Currently [this was written in mid-January 1971] no buying or selling is taking place'. He proceeded to say cautiously that the market was expected to 'bottom' within the next six months, and perhaps inside two months, 'which may enable some profitable trading to take place on a limited scale.'

In the same month of December, nevertheless, Mineral Securities and two only of its subsidiaries bought $9.9 million of shares in the market, completing a four-month buying wave of $56 million. The greater part of the money went to buy four stocks: Queensland Mines (net purchases $16.5 million), Kathleen Investments ($11 million), Robe River ($7.4 million) and Thiess Holdings ($2.6 million). It was not intended that any of these stocks would be quickly re-sold (some of them having been bought as part of the PRA project); but the company raised no additional share capital or long-term borrowings before the buying wave began. Instead, it raised $50 million in the short-term money markets, and especially the inter-company market. All of the money was at first repayable within 12 months, and although the term-composition varied later, rather more than a quarter of the borrowings appear to have been rEv.lving on 24-hour call. Later in this chapter, we return to a discussion of this apparently irresponsible behaviour.

While it is likely that the legion of new creditors to Mineral Securities had no idea of the collective size of the company's liabilities or the transformation these brought to the gearing of its debt to shareholder funds, it is certain they did not suspect that the public references to its profit experience which their debtor was making were based on gross accounting fabrications. The best available indication of the change that overtook the company's financial structure is given by a synoptic balance sheet which Mr Nestel included in his half-yearly report to other directors. His table gives the comparative figures at 30 June and 31 December 1970 for Mineral Securities and two of its subsidiaries which were engaged in share purchasing. It shows nearly a fourfold rise in current liabilities (from $23.7 million to $86.4 million) in the six months. We print Mr Nestel's table, adding a footnote to indicate the adjustments which subsequently had to be made after the correction of the original claimed profit for the December half-year (Table 14-9).

Elsewhere in his half-yearly report Mr Nestel indicated that net borrowings from brokers had fallen to about $7.7 million by 31 December, and that about half of the increase in 'current assets' shown in the table represented advances from Mineral Securities to subsidiary companies. On Mr Nestel's figures, the net current indebtedness of Mineral Securities had increased threefold in the six months. When corrected for the true profit-and-loss experience, the circumstances of which were known to directors of Mineral Securities, the gearing of shareholder funds to outside liabilities had changed in six months from a ratio of three-to-two to a ratio of less than three-to-eight - and all of the additional liabilities appear to have had less than 12 months' currency.

TABLE 14-9

BALANCE SHEET, MINERAL SECURITIES AUSTRALIA LIMITED, MINSEC INVESTMENTS PTY LIMITED, NORAUSAM PTY LIMITED

$

30 June 1970		31 December 1970	
	Issued Capital		
4.5	Ordinary	4.5	
5.7	Preference	5.7	10.2
	Capital Reserves		
13.4	Share Premium	13.4	
2.0	Capital Profits	2.0	15.4
	Revenue Reserves		
-	Tax Exempt	-	
10.1	Unappropriated Profits		13.2*
35.7	Share Capital and Reserves		38.8
	Represented by:-		
23.7	Current Liabilities - less than 12 months		86.4
	Less		
3.8	Current Assets		23.9
19.9	Net Short Term Indebtedness		62.5
-	Liabilities - after 12 months		-
19.9	TOTAL Net Indebtedness		62.5
52.2	Investments		97.7*
3.6	Convertible Loan to Robe River Limited		3.6
$35.7			$38.8

** Subject to subsequent reduction of $6.8 m in 'Unappropriated profits' and in 'Investments', upon correction of half-yearly profit statement*

According to Mr Nestel's half-yearly statement, about $28.5 million of the short-term loans held at 51 December were unsecured, and of these, $20 million were repayable on call. The further $20.2 million of loans which were secured had often been made against the surety of shares having a ruling market price of 50 per cent above the amount of the agreed loan, and in the event of the market prices subsequently falling the lender had the right to demand additional share scrip to cover his margin (Mr Jamison, Ev. 2968). Some of the corporate lenders to Mineral Securities appeared in the lists of secured and unsecured creditors.

Obviously this was an extremely precarious structure. There was a possibility that the cessation or easing of the rate of Mineral Securities' own buying of the shares it had been concentrating upon would be sufficient to bring about a perceptible easing of each of the prices at about the same time; such a weakening in the market could prompt demands from numbers of secured creditors for increased quantities of each class of scrip; their simultaneous demands could be difficult to meet; any delays or attempts to negotiate over the provision of scrip would be likely to become a matter of notice in the short-term markets and would affect the chances of renewing money borrowed at call or on short notice; if the renewals fell off, Mineral Securities of itself would be helpless to resist insolvency. Any general tendency towards downturn in the share market, or more precisely in the volatile mineral section, would be liable to produce similar results. In fact, the general share market had begun to turn down just as Mineral Securities commenced its heavy sortie into the uranium and other mining stocks in September. The Sydney 'all ordinaries' monthly average index of share prices fell as follows:

1970-	August	... 581.12
	September	... 580.72
	October	... 568.77
	November	... 525.05
	December	... 515.54
1971-	January	... 502.28

Finally, the weakness began to be transmitted to stocks which were of central significance to Mineral Securities. This was most noticeable after Mineral Securities' own purchases tapered off in December (see Table 14-10).

TABLE 14-10

END OF MONTH PRICES OF CERTAIN SHARES SYDNEY STOCK EXCHANGE

	1970 July	1971 Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.
Robe River	-	1.70	2.20	2.30	2.52	2.35	1.95	Suspended
Queensland Mines	7.50	11.20	42.00	31.00	37.00	30.00	25.00	20.50
Kathleen Investments	4.00	4.80	15.50	15.60	15.20	11.80	9.30	8.72

Mr Jamison, in evidence to the Committee, suggested also that early doubts about the Mineral Securities' declared profit contributed to the deadly dynamics of the process. He said:

They made their first announcement of that profit in January. By this time it had become clear that the market had taken such a tumble that they possibly would not be able to go on with their plans to float off as a separate company the QM and KI shares plus some Thiess shares that had been included in that buy. There were some doubts expressed as to their disclosed profit. This ... resulted in them making a reverse announcement of profit and turning the profit of $5.5 m. into a loss of $5 point something m. At the same time, because the market was falling, people who were holding security on this 1½ times [basis] were saying: 'Under the terms of our security we should have 1½ times scrip. We want more scrip because the value in the market has fallen and we are not holding 1½ times'. In a lot of cases they gave more scrip, but sooner or later - I think it was sooner - they ran out of scrip. They found themselves in a position where they were unable to add more scrip to bolster the security up to the promised amount and then they started getting calls. Very quickly it happened that they were unable to finance themselves - over a matter of no more than eight days from when the calls started coming on them. They called in Mr Ken Humphreys of Irish, Young & Outhwaite [Chartered accountants from Sydney]. He did a report, and I think he was responsible for the meeting in Kirribilli House.

(Ev. 2968-69)

Crisis in the Money Markets

The decision of the Prime Minister, the Right Honourable J.G. Gorton, to call a meeting of about thirty prominent financiers, including some creditors of Mineral Securities, at his official Sydney residence, Kirribilli House, on Tuesday, 9 February 1971 was taken largely on the advice of a number of financiers and businessmen who saw a danger that the sudden exposure of the insolvency of a company owing such great amounts in the short-term money market could have serious repercussions in that market and on the liquidity of various companies, and could damage Australia's borrowing status abroad. There was also a desire to prevent, if possible, the passing into overseas hands of the principal mining assets of Mineral Securities which would be sold in a liquidation.

There had already been a number of urgent meetings of creditors and others to consider lines of action from the insolvency of Mineral Securities. The earliest meetings of creditors on 5 and 4 February had been arranged by members of the merchant bank, Ord-BT Co. Ltd, in their Sydney offices. The second and larger of these was attended by representatives of

Ord-BT, King & Yuill Investments Ltd, Westralian International Ltd, Elders Finance & Investment Co. Ltd, Patrick Partners, Bill Acceptance Ltd, Trans City Discount Ltd, the ANZ Banking Group, Chase-N.B.A. Group Ltd, Commercial Continental Ltd and Waltons Ltd. Several affidavits filed in the Supreme Court of New South Wales in proceedings for the winding up of Mineral Securities have described the first creditors' meetings and also testified to harried last-minute attempts which had been made by some unsecured creditors to obtain some form of charge over Mineral Securities assets in the previous few days. While the representatives of Ord-BT emphasised at the meetings the widespread consequences that could attend a 'disorderly liquidation', and invited those present to explore the possibilities of joining in a 'rescue operation', the proceedings ended inconclusively. A more significant gathering at a Sydney hotel on Sunday, 7 February had included representatives of the Reserve Bank, the Bank of New South Wales and others who were to be present at the Prime Minister's meeting two days later.

The roll-call of attendances at the early meetings called by Ord-BT, while it includes many of the biggest professional-financier creditors of Mineral Securities, does not convey the wide range of industrial and commercial organisations which also were substantially involved in this company's failure. Among the companies which were listed as unsecured creditors through the money market to Mineral Securities in the Official Liquidator's statement of affairs at 11 February 1971 were the following: Associated Securities Ltd, $301,952; Australian Mining & Industrial Corporation Ltd, $200,296; Castlereagh Securities Ltd, $302,330; Commercial Continental Ltd, $856,214; Development Underwriting Ltd, $1,057,283; Elders Finance & Investment Coo Ltd, $504,747; J. Fielding and Co. Ltd, $151,123; A.V. Jennings Industries Ltd, $302,244; King & Yuill Investments Ltd, $2,021,764; Mobil Oil $1,001,315; Myer Emporium Ltd,

$503,740; Partnership Pacific Ltd, $505,054; W.C. Penfold & Coo Ltd, $226,986; South British Insurance Co. Ltd, $302,445; Supervised Investments Ltd, $404,064; Switzerland Life Assurance, $201,152; Trans City Securities Ltd, $1,004,766; Waltons Ltd, $955,271; Western Mining Corporation Ltd, $300,427; Westmoreland Minerals Ltd, $151,581; Westralian International Ltd, $2,012,541; 0rd-BT Co. Ltd, $1,715,879; Robe River Ltd, $1,012,144. Some of these companies also appeared among the secured creditors of Mineral Securities.

At the meeting held in Kirribilli House on the evening of 9 February - five days after the first hints of crisis in the affairs of Mineral Securities - it is reported that there was some canvassing of the question as to how far the secured creditors would be prepared to co-operate in the orderly bulk marketing of the Minsec assets, to the extent of foregoing legal rights over specific assets. The representatives of secured creditors who were present are reported to have shown small enthusiasm for suggestions that they might consider waiving some of their rights. No firm conclusions were reached at this meeting, though it has been suggested that the sense of national concern it conveyed may have had a bearing on the subsequent relationship between some creditors who claimed to have a secured status and the Official Liquidator, Mr Jamison, when he moved to assert firm command over the disposal of all the asset of Mineral Securities. It was also partly as a development from the discussions at Kirribilli House that a consortium of trading banks and other companies, led by the Bank of New South Wales, proceeded to make an offer to the liquidator of a line of standby credit to $35 million. Unlike the proceedings at Kirribilli House, the consortium's offer was widely publicised, though the public did not know for several months that a condition attaching to the offer had made Mr Jamison decide very early that he could not use the standby credit. This condition stipulated that the liquidator would have to satisfy himself and accept responsibility for deciding that the security held by the creditors of Mineral Securities whom he paid out was good for the amount of $35 million. When Mr Jamison informed the secured creditors privately that he was unable to draw on the $35 million for this reason, he asked them 'not to make this public' (Ev. 2970).

In the meantime, some trading banks took individual action to relieve the pressures on creditors of Mineral Securities who were in stringency as a result of their inability to retrieve large balances placed with that company. In particular, the Bank of New South Wales took over, as a first charge loan, a secured credit amounting to more than $6 million that a money market company, which was associated with a broking firm, had made available to Mineral Securities.

The Reserve Bank of Australia, while it had not participated in the formation of the consortium or in direct initiatives to relieve the strains on creditors of Mineral Securities, sent a message to the trading banks on 10 February 1971, the day after the meeting at Kirribilli House. Without mentioning Mineral Securities by name, the Governor of the Reserve Bank said he wished to be kept informed of any important developments in the financial markets, told the banks to exercise their commercial judgment in dealing with customers and said the Reserve Bank 'stands ready to support as necessary the actions of the banks', evidently intending to convey that the Reserve Bank would relieve what it considered to be any undue strains on the banks' liquidity resulting from lending commitments to ease the pressures on the money markets. The Governor also pointed to new opportunities that would be given to the banks in an unsettled money market to endorse commercial bills and deal in such bills. He encouraged the banks to take opportunities for dealing in bills, and left open the question whether this was being proposed as a temporary or a long-term policy of influencing the status of commercial paper in the markets. The text of the Reserve Bank Governor's message read as follows:

In view of the current events in the financial markets we are particularly concerned to keep in touch with the situation and be made aware of any important developments. Banks are probably better placed than anyone to get a full picture and I would be grateful if you could keep us as fully informed as possible. In particular I would be interested in such matters as the extent of demands for loans being made on you by those affected either directly or indirectly by a lack of confidence in the markets; the extent of demands to have non-bank bills endorsed etc. by you; whether effects go beyond financial companies and intermediaries.

If confidence falters in other markets the banking system is the obvious sector to which the public will turn. In this event I would expect banks to respond to the situation according to their commercial judgment but in the knowledge that the Reserve Bank stands ready to support as necessary the actions of the banks.

One aspect of the present situation appears to be that investors are looking much more closely at the status of borrowers and of paper which is offered as security for loans. I think it particularly desirable that the undoubted standing of bank bills be recognised at this time and would expect that banks would, in appropriate cases, be ready to deal in such bills.

I would be grateful for your co-operation in keeping us fully informed as quickly as possible of anything which you think is relevant to the present situation.

In the event, special Reserve Bank assistance to the trading barks was not needed. The Committee has interested itself in the question of the impact made by the failure of Mineral Securities upon the money markets and the broking industry, with its close associations with those markets, not as an exercise in contemplating what might have been, but for insights it could offer into the inter-related workings of sections of the financial system. Since the collapse of Mineral Securities did not produce a chain reaction of failures in other companies or broking firms, it is proper to treat with care suggestions that such reactions were at one time imminent. Before accepting such estimates, it would be necessary to establish an explanation of the reasons why such dire consequences were averted, and to consider how far the system shows innate powers to contain its shocks and minimise the reverberations from them. It would be hard to give definitive answers to these questions, and in the conditions of our inquiry we do not consider it is necessary to provide final answers, but the circumstances existing after the failure of this company are deserving of notice.

The Role of the Liquidator

We begin a brief review of the circumstances by considering how they were seen through the eyes of the Official Liquidator, Mr Jamison, noting the policies and expedients he adopted to cope with them. His general strategy seems pivotal in the sequence of events after the collapse. The value to an Official Liquidator of the consortium's unusable offer of credit, like the value to him of the talks at Kirribilli House which he did not attend, could only be described as transient and intangible. One would not readily expect such events as these in themselves to decide the issue of success or failure to restore stability to the money markets. Yet a succession of witnesses having first-hand acquaintance with the markets emphasised to us the psychological value of the consortium's gesture in the conditions which the witnesses saw existing in February 1971 when psychological considerations were important. We do not dismiss this testimony, but are inclined rather to consider the distinctive use that Mr Jamison made of the consortium's offer as a part of overall strategy which was clearly an appreciable factor in restoring and maintaining stability. It was a somewhat fortuitous factor, in the sense that the liquidator of Mineral Securities cannot be said to have taken a merely routine or narrowly legalistic view of his function.

The primary purpose behind the consortium's offer of a $35 million line of credit to the liquidator had been to permit an orderly selling of investments held by Mineral Securities, giving him scope for the selling in one lot of controlling interests in several mining companies where he estimated that this would maximise the prices obtainable (Ev. 2970). But Mr Jamison's formal Statement of Affairs for Mineral Securities (parent company) drawn up on 1 March and giving the estimated position as at 11 February 1971, shows the total of secured (or claiming to be secured) creditors as standing at $49.1 million while the total for unsecured creditors was $21.2 million. The cost or book value of the scrip over which the secured creditors claimed to have charges was $51.78 million, but already Mr Jamison estimated in February 1971 that the realisable value was almost $10 million below the book figure, which would make them $7 million less than the claims of secured creditors. These figures, on which the consortium presumably had a degree of information, help to make it understandable why Mr Jamison was unwilling to make use of the $35 million line of credit on the conditions laid down, for this would enable him to pay off some only of the creditors who claimed to have charges over scrip, and would leave him holding shares of uncertain realisable values. Advice he had received throwing doubt on the legal status of many of these creditor's claims to have charges over scrip reinforced his decision not to use the consortium's offer. Mr Jamison and his legal adviser in the liquidation, Mr G.D. Applegate, told us that in some cases they had even found that documents being held in the office of Mineral Securities on behalf of other interests appeared to have been used as security to obtain loans for Mineral Securities. These documents were negotiable share certificates, and persons taking them as security would have had no reason to doubt that the borrower had title to them. The presence of some of the documents in Mineral Securities' office was connected with back-to-back borrowing arrangements, and it was uncertain as to how far the notations made regarding some of the arrangements could be taken as formal records.

Mr Applegate : It is difficult to say what constitutes the records of the company when the liquidator took over ... On a number of investment cards, written in pencil, are the words: 'back-to-back RRL'. Who wrote it, we do not know but I think I know what it means. Whether it is part of the official records of Mineral Securities we do not know, but it is there.

Senator Lawtie: What does RRL stand for?

Mr Applegate: Robe River Ltd.

(Ev. 2975)

Mr Jamison decided to turn these uncertainties to wider account. Giving evidence to the Committee in October 1971, he explained how he had resolved early in the liquidation to resist the desire of some secured creditors to acquire and sell on their own account the shares to which they made claim. 'The essential thing', he said, 'is that if action had not been taken, they would all have attempted to sell the securities they held, and they would have further depressed the market and would have received a lot less than was actually obtained by orderly later selling by the liquidator' (Ev. 2970). Without conceding a legal obligation to do so, he indicated that he was ready to listen to any cases of serious trouble which were put to him in private. This applied particularly to some of the creditors who were claiming security in the form of shares in Queensland Mines and Kathleen Investments. Something of his pragmatic policy in dealing with the secured creditors is conveyed in the following passage of his evidence.

... I think it is clear that when, as a general principle of liquidation, you feel, and your legal adviser tells you, the security is no good, you know that the lawyers on the other side know that too. I think this was the reason in this case why nobody actually took action to sell their scrip over which they claimed security. Some took action, but we talked to them. Talking to these creditors, we realised that some were claiming to be in dire financial straits. It was also clear that the ones who were in the worst financial position were the ones who had come in towards the end. I have no theory as to why this happened - whether it is just coincidental or whether they came in, getting QM and KI shares as security, when QM and KI shares were at a tremendous price. The prices dropped from $45 to $25 over a period of months. They were worried about their security having lost value and being less than the amount they had advanced. The people who were mainly in financial trouble were those holding QM and KI shares. My knowledge of people in trouble is restricted entirely to conversations with them. I was not interested, nor did I have the time, to examine whether they were really in financial trouble. I accepted their statements. At meetings of the creditors claiming security in QM and KI shares, in the very early days of the liquidation, I asked any who were in trouble to see me privately. I realised that they did not want to do it publicly at a meeting of creditors. I did the same thing with the general creditors when we had a meeting of secured creditors some days later. Under that invitation no more than one or two saw me. It was just a general attitude of shortage of money, because money had been lent to MSAL, in lots of cases at call and on short term, and they realised they would not get it back. Again I think you have to look at the quantum of this. The total creditors of MSAL and its group in respect of monies advanced, omitting brokers and ordinary trade creditors, amounted to something like $70 million. If you took $70 million, even in a boom time, overnight out of the money market, it must have an effect...

(Ev. 2969)

While the short-term money market was adjusting to the fact that $70 million of its balances was locked in one failed company, Mr Jamison made psychological use of the consortium's offer of standby credit. Though he promptly told the parties who were directly concerned, including the secured creditors as well as members of the consortium, that he could not accept the offer in the form made, the withholding of this information from the general public for about three months 'was a way of stopping panic', he told the Committee. 'o.. In fact, it did not become public until I tipped the bucket of cold water on it in Perth [referring to a Press statement Mr Jamison made on 10 May 1971]. I think this was a good thing' (Ev. 2970). At first, he had entertained the idea of approaching 'the consortium or even the Government to see if we could not use the $35 million with Government backing and convert it into a use that could be done for all creditors claiming security'. This option would have been conditional on adequate security residing in the assets of Mineral Securities for a full settlement of debts. Mr Jamison said he had told the first meeting of creditors of his proposal, but after the change in the Prime Ministership in March 1971, he had, on legal advice, proceeded with a different scheme with the result that he had been able, on the same day as he gave evidence to the Committee (12 October 1971), to pay the last of the creditors who had claimed to have security (Ev. 2970).

We have been informed that the broad nature of Mr Jamison's revised scheme was that, from the money proceeds of the assets sold, he would pay out all creditors who claimed to be secured, on the explicit understanding that he might take action to 'claw back' part of the money if the total proceeds from the disposal of assets eventually proved insufficient to meet the debts owing to unsecured creditors. By this means, Mr Jamison ceased to incur cumulative interest liabilities on the debts to the creditors who claimed to be secured, and he estimated that he retained a strong position in relation to many of these creditors after making the provisional payments to them because of the scope he saw for legally challenging their claims to have had security. With this scheme put into effect, some other aspects of the liquidation, including final settlements for unsecured creditors, have not yet been accomplished.

Three Merchant Banks as Creditors

In the course of his evidence to us, Mr Jamison spoke of several creditors who had approached him and '... said straight out that they were in danger, and that if things did not happen they would go into liquidation' (Ev. 2973). When invited to outline the circumstances of the more significant examples, he referred in particular to three major creditors. He said that each of them might be described as a short-term money market operator or a finance house or a merchant bank. Mineral Securities at the time of its failure owed these three companies respectively $5 million, $8 million and $9 million. They are not named in the evidence given by Mr Jamison and Mr Applegate (Ev. 2973-78), but by arrangement with the Committee he referred to them as creditors No.1, No.2 and No. 3.

The first creditor for $5 million was 'one of the few that did have an executed document' nominating security for the loan. When Mr Jamison was asked whether this loan was fully covered by the security, he gave an affirmative answer, qualified by a reference to the subsequent sharp deterioration of the value of the shares which had comprised the security. These were mostly shares connected with the Nabarlek uranium deposit. He said 'Let me put it another way. As a result of the non-fragmentation and of the quick sale of the Queensland Mines and Kathleen Investments shares, the sale of those was more than sufficient to produce the $5 million. In addition they were holding 100,000 shares in Thiess ... If their security was good legally sound they would have been well secured at the time. They would not now' (Ev. 2974). Mr Jamison as liquidator sold the shares in Queensland Mines, and its associate Kathleen Investments before the drastic downwards revision of the company's official estimates of its ore richness was made public and brought further sharp reductions in the prices of the shares.

In the case of the second company, which lent $8 million to Mineral Securities, information that the creditor was in difficulties had come to Mr Jamison from a member '... of the stock broking firm associated with the company' (Ev. 2977). The stockbroker had told him that there had been a run on this company (withdrawals by its own creditors) amounting to $67 million in six days at the time of Mineral Securities' collapse. He had refreshed his memory on this by again speaking to the broker when he was preparing to give evidence to this Committee in October 1971, and the figure of $67 million had then been confirmed (Ev. 2977). In the following passage, Mr Jamison refers to the involvement of the stockbroking firm in the fortunes of this creditor to Minsec:

Senator Rae: The point I make is this: You had a discussion on behalf of creditor No.2 on the list you have given us. That was with a person who may or may not be a director of that company but who is certainly a member of an associated stock broking firm. In the discussions you had, did he say anything to you as to the potential effect on his stockbroking firm if No.2 had to go into liquidation~

Mr Jamison: I was under the impression that they were just as worried that if No.2 went the stockbroking firm would follow. In fact, to support themselves, the members of the stockbroking firm had to put in all their personal assets ... I really should say that that is on rumour, but we know for a fact that it is true because we helped them with this last $5 million and they had to disclose their hand to us a bit. I do not quite know how you are going to use this.

Senator Rae: You may put whatever qualifications you wish on anything you say. It is a matter of our trying to draw the strings together on the evidence we have.

Mr Jamison: There is no doubt that the individual assets of the members of the stockbroking firm were pledged to support the other company - No.2

(Ev. 2977-78)

On the nature of the security held by 'creditor No.2', Mr Jamison and Mr Applegate reported an extremely confused situation, involving some of the back-to-back transactions and apparently duplicated roles for some documents of a kind to which we have previously referred. Originally, this creditor's loan of $8 million had been supported by a document in the form of a general charge, relating to all moneys owing from time to time. This was amended~ 'perhaps unsuitably to meet the particular circumstances', when it accorded with the creditor's objectives for a time actually to reduce the amount of security that it claimed to hold from Mineral Securities from $8 million to $5 million. This curious development arose from the fact that the creditor obtained temporary finance from its bank to the extent of only $5 million, and 'to do that it had to surrender all the security it held from Mineral Securities. So for that reason ... it claimed that all the security it held related only to $5 million ... but I also point out that as soon as the bank had been paid out they then said that the whole $8 million was secured' (Ev. 2975).

The third merchant banking creditor, which had a total amount of $9 million on loan to Mineral Securities at the time of its failure, had entered into 'a very unusual type of security arrangement' (Ev. 2976) in respect of $5 million of it. There were four parties in this arrangement: the merchant bank, a firm of stockbrokers associated with it, a nominee company associated with the brokers and, finally, Mineral Securities. Mr Applegate described the arrangement as follows: 'It involved the financing of Mineral Securities by the merchant bank to enable Mineral Securities to buy shares through the broking house which were put into the name of the nominee company. In fact, the nominee company borrowed the money from the merchant bank, and Mineral Securities executed a form of guarantee for those moneys' (Ev. 2976): the guarantee being given to the merchant bank.

Senator Lawrie: Was this on the condition that the shares were bought through this broking firm?

Mr Applegate: I do not know that that was specifically made a condition, but one could assume that it would be done that way.

(Ev. 2976)

Senator Lawrie's question appears to be pertinent, for the brokerage commission chargeable to Mineral Securities upon the execution of some $3 million of share purchases would be between $45,000 and $60,000; and the broker, being associated both with the nominee company in whose name the shares were placed when bought and with the merchant bank that financed the purchases, had a linking role with the three other parties. We have evidence that this broker bought more than $6 million of shares in Queensland Mines and more than $1 million of shares in Kathleen Investments on behalf of Mineral Securities in the month of September 1970. This broker and the associated nominee company also served the cause of Mineral Securities in other ways, being themselves substantial direct creditors to that company when it failed (Ev. 9876-77).

Concerning the balance of $6 million lent by the third merchant bank to Mineral Securities, Mr Jamison and Mr Applegate testified that there was no security apart from a letter written by the lender, not the borrower, at the moment of Mineral

Securities' collapse on 3 February 1971, and appearing to have little or no binding effect. They also said that this merchant bank was eventually obliged to apply to its United States associates for relief from its financial difficulties. We quote a passage of the evidence:

Mr Applegate: ... The balance was moneys on deposit either at call or long term from time to time, and was secured by - and I used the word loosely - a letter written on 3rd February.

Senator Rae: Although the moneys had been deposited considerably earlier?

Mr Applegate: That is right.

Senator Rae: Was the letter any more than simple evidence of an acknowledgement of the loan of some form?

Mr Applegate: No. In fact, it was a letter from the creditor to the company. I cannot remember exactly what it said, but it was to this effect: We have agreed to advance you a further sum of money in consideration of your acknowledging that all our amounts are secured.

Senator Rae: Secured in what way?

Mr Applegate: It c lid not specify.

Senator Rae: The last explanation you have given us is in relation to $6 million?

Mr Applegate: That is right.

Senator Rae: That particular merchant banker, No. 3, was one of those who claimed to you to be seriously at risk as to whether it could remain solvent~ remain out of liquidation; is that right?

Mr Jamison: It certainly claimed that it had great liquidity problems. It also explained how it was hoping to get finance, but I cannot think of what it said.

Senator Rae: It is a company which, as I understand it, is backed by a number of overseas companies.

Mr Jamison: That is where they got it.

Senator Rae: One imagines that they were calling on those companies.

Mr Jamison: I think the conversation with me was before they had plucked up courage to go to the States to get the help they finally did get.

(Ev. 2976-77)

The above summary of the liquidator's evidence regarding three big creditors of Mineral Securities who had indicated to him that they were not certain whether they would be able to continue in business or would themselves be forced into liquidation highlights the seriousness of the repercussions of the company's failure to the stability of the stock exchanges as well as to the money market. The combined loans made by these three creditors to Mineral Securities amounted at the time of its failure to nearly $23 million, or about one-third of its liabilities. Following his negotiations with these creditors, Mr Jamison made a statement to the Press from Perth in May 1971, when the pressures had eased. He acknowledged that the consortium's offer of standby credit had been unusable, and said: 'When Minsec collapsed, it looked as though it would create or promote a whole lot of crashes'. His press statement also said that it had been in the interest of the national economy that the public should know the money was available, but if he had revealed then that he could not use it the offer would not have had such an effect. When asked whether he thought there could have been a 'domino effect of crashes in the shares of Minsec creditors', Mr Jamison was reported as saying that he thought there would have been. (The Age, 11 May 1971)

The big creditors had given Mr Jamison most concern. He told the Committee that several smaller ones came to him with their problems, but that was after the early phases of acute emergency. 'By that time', he said, 'we were able to help them by speaking to their bank and saying: "Look here, these fellows are going to get some money. They tell us they are in trouble. Carry them on". This usually worked' (Ev. 2973).

The Committee, in the course of taking evidence from witnesses having direct acquaintance with the money markets, received other assessments of the impact that the collapse of Mineral Securities had in those markets and on the question of the significance of the liquidator's and consortium's contribution to the maintenance of stability in them. Mr Roderick Howard Carnegie, the Executive Director of Conzinc Riotinto of Australia Ltd, appearing before the Committee in March 1971, offered reasons why his company had taken an initiating role in the discussions which brought the consortium into being. It had been one of four companies which sponsored a preliminary meeting of prominent businessmen in a Sydney hotel on Sunday 7 February 1971 to consider the situation (the other sponsors being the Bank of New South Wales, the Colonial Sugar Refining Company Ltd and Consolidated Gold Fields Australia Ltd), and before that meeting Conzinc Riotinto had assisted in the transmission of warning messages to Government authorities in Canberra which helped to bring about the gathering at Kirribilli House on 9 February. Mr Carnegie told the Committee that his company was regularly in a position robe a large lender on short term, having money balances which ranged from about $60 million to $160 million in the course of a typical year. As part of its business, the company had therefore carried out an examination of conditions in the Australian short-term money markets and the classes of borrowers who drew from the market. It had noticed a lack of updating of published information on the balance-sheet positions of borrowers. Conzinc Riotinto had not lent any money to Mineral Securities. Its feelings of concern in February 1971 had, he said, 'stemmed largely from the fact that some of the people who lent money to Mineral Securities were, in turn, short term borrowers. They had borrowed on ratios of debt to equity which would be unacceptable elsewhere in the world, and they had no "lender of last resort" facilities. In the case of short term borrowings - a period of 50 days or something of this nature - when there is a panic or worry it can start a very substantial chain reaction' (Ev. 1105). Mr Carnegie said that the object in forming the consortium 'was essentially to provide a breathing space, and I think that has been achieved ... The very fact that the consortium was able to be put together gave everybody a feeling that steps were going to be taken to allow things to be handled in an orderly rather than a panic fashion' (Ev. 1103-04).

The Pressures on King & Yuill Investments

Other evidence was given by Mr John Henry Northcott, the general manager and later a director of King & Yuill Investments Ltd, a money market dealer which had large amounts on loan to Mineral Securities at the time of that company's failure and was caught up in some of the complication which beset the money market. King & Yuill Investments is a member of a group of companies constructed around the Sydney broking firm of Ralph W. King & Yuill. The holding company in the group is Australian Investment & Development Ltd, which is listed on the stock exchange. At the time of Mr Northcott's appearance before the Committee in June 1971, the biggest shareholders in Australian Investment & Development Ltd were partners of Ralph W. King & Yuill, who could be said to have effectively a controlling interest. Other large shareholders were the Bank of New South Wales Superannuation Fund, the Mutual Life and Citizens' Assurance Company Ltd and the Producers and Citizens Life Insurance Company (Ev. 1527-28). The two most important subsidiaries (51 per cent owned) of Australian Investment & Development are Short Term Acceptances Ltd, an authorised dealer in the market in Government securities which is regulated by the Reserve Bank of Australia, and King & Yuill Investments, operating in money markets which are not under Reserve Bank supervision (sometimes known as the 'unauthorised' markets, though the word should not be taken to mean anything more than 'not subject to official regulations'). At the time of our hearing, the remaining 49 per cent of the shares in King & Yuill Investments, like most of the 49 per cent remainder in Short Term Acceptances, were held by partners of the broking firm (Ev. 1527-28). There were no big overseas shareholders in this group of companies.

At the time of Mineral Securities' failure, Mr Northcott said, the gearing of the liabilities of King & Yuill Investments to its shareholder funds was abnormally high because the company had made a special loan of about $26 million to the brokers Ralph W. King & Yuill for a period of about four weeks to permit the brokers to acquire Commonwealth Government bonds of that value, with a view to obtaining the interest payments from the bonds which were falling due and carried special taxation rebates. This is a well known practice, sometimes described as 'bond washing' (Ev. 1529-50). King & Yuill Investments itself had specially bought these bonds, borrowing on the security of the bonds for the purpose, and had re-sold them to the broker on credit. The bonds could be quickly liquidated, if necessary.

The paid capital of King & Yuill Investments was $500,000, and Mr Northcott estimated that its liabilities were usually about 15 or 20 times as much as that, but the bond washing transactions, added to some seasonal factors, had greatly increased that gearing at the end of January 1971. Mr Northcott said that of the funds deposited by clients with King & Yuill Investments at that time, about 43 per cent (or some $20 million) came from banks, nearly six per cent from finance companies and 5½ per cent from semi-government bodies. Of the total of $46.6 million deposits, some $28 million had been re-lent (mostly to Ralph W. King & Yuill for the bond washing transactions), and the remainder was invested in government securities, transferable certificates of deposit, bank acceptance bills and other bills. Usually, funds deposited or lent to King & Yuill Investments were 'for the most part invested in securities, not lent on to somebody else.' At the same time, his company acted as an agent in arranging inter-company lending and borrowing transactions; the volume of such inter-company loans outstanding in its books averaged between $40 million and $45 million over a year, and had touched a peak of $52 million at the end of the previous financial year (Ev. 1527, 1540-41, 1548).

On the day after the public announcement of Mineral Securities' difficulties and the drastically corrected profit statement, King & Yuill Investments experienced abnormal demands from depositors for the withdrawal of their funds, and found that the securities which it then held were not acceptable as collateral for its own further borrowing. On that day, Friday, 5 February 1971, the company had an immediate liquidity shortage in meeting some $1.2 million of the calls made on it. The position was relieved on the Friday afternoon by the broking firm of Ralph W. King & Yuill, who deposited that exact amount of money with King & Yuill Investments against the security of Mineral Securities bills, though the bills were at that time commercially unacceptable in the market. On the following Monday, the company's own bankers agreed to provide short-term funds after they were offered different security. Mr Northcott said: 'We had existing standby credits at bankers and other places on the Thursday-Friday, but it was no use trying to borrow from them against the worthless Minsec paper. By Monday we were able to marshall other securities which enabled the bankers to provide us with overdraft facilities' (Ev. 1544).

While King & Yuill Investments experienced an immediate run on its funds because of its known character as a large creditor to Mineral Securities, Mr Northcott said it had been his observation that the whole money market was placed under a good deal of pressure in February 1971. He said: 'Large institutions called substantial funds from the marketplace generally and redeposited those funds either back in the banking system or with the authorised dealers ... I am referring to the whole of the short end of the capital market which includes the official market, the unofficial market and merchant banks - the whole range of intermediaries - on whom these calls were made. They accelerated somewhat, and I would say that all financial intermediaries operating in the short end of the capital market experienced some run on their books' (Ev. 1542). He said the calling began on those intermediaries who were known to be involved in dealings with Mineral Securities, and extended beyond them. In the passage of subsequent evidence which is now to be quoted, answers to the Committee's questions are given both by Mr J.H. Northcott and Mr Thomas Meaney Northcott, the assistant general manager of King & Yuill Investments Ltd:

Senator Rae: And that run extended right through all the areas and all the operators in the short end capital market?

Mr J.H. Northcott: It is my understanding that no-one went unscathed.

Senator Rae: That started before the full details of the problems of Mineral Securities were made public?

Mr T.M. Northeott: It began on 2 February.

Senator Rae: And on 2 February, it is my understanding from the evidence given to this Committee, Mineral Securities did not know the full extent of its problems, let alone anybody else?

Mr T.M. Northcott: That is so.

Senator Rae: Then the liquidator of Mineral Securities subsequently made a statement in Perth -that was recently - as to his fears at one time for the possible repercussive effects or the domino effects on the capital market in Australia because of the position in which Mineral Securities found itself in early February 1971 ... Is that a statement with which you would agree - that you would see the possibility of the results from the Mineral Securities problem being repercussive, particularly through the short term end of the capital market in Australia and having potentially serious effects on that market?

Mr J.H. Northcott: Yes, it definitely did~

Senator Rae: To use a quote from the Melbourne 'Age' of 11 May 1971, Mr Jamison, the liquidator of Mineral Securities is quoted as saying as follows ---

Chairman: That was in Perth.

Senator Rae: Yes. He said: 'When Minsec collapsed, it looked as though it would create or promote a whole lot of crashes'. Again, is that something with which you would agree? I emphasise he said that it looked as though it would create or promote a whole lot of crashes.

Mr J.H. Northcott: I think it is a fair statement to make. Of course, we are in the realms of theory rather than actuality here, but I would be inclined to agree with it. I do feel that if one well-known or large intermediary had failed as a result of the Minsec crisis it could well have had a domino effect and increased or accelerated the run that was already evident in the market place.

(Ev. 1542-43)

When Mr Northcott was asked whether he thought that the course of developments might have been different if the consortium had not announced its offer of standby credit, he said that the offer had steadied the market. He continued: 'People - by people I mean large lenders and investors to the market generally - saw that this thing would not be allowed to get out of hand, that it would not be allowed to follow the crashes we have known in our past financial history and they themselves acted, I think, more responsibly, if that is the right word ... I felt that it did a lot to stop panic' (Ev. 1544).

The Committee also received evidence in camera and other information relating to conditions in the money markets, to the associations of some market dealers with brokers and the pressures brought on the markets by the failure of Mineral Securities. The tenor of this evidence, as it related to the pressures on the market, was in the same general direction as the public evidence from which we have quoted, some of it entering into more detail than was given in open hearings. We were also informed of a belated scramble among several big creditors to obtain a form of security for their loans when the company was evidently on the point of collapse, and was in no position to resist such short-term creditors' demands. This action affected the relative status of other lenders, not only unsecured ones but also others who claimed to have charges of a general character over the assets. The history of the Minsec creditors throws light on some neglected areas of financing conventions which might repay further study in the legal and accountancy professions.

The evidence we have received, and partly quoted, indicates that the situation in February 1971 was extremely serious. There were pockets of great over-extension in financing the failed debtor, and if any of these had led to a secondary failure to meet commitments the condition of insolvency could have been transmitted quickly in the climate then prevailing. Two of the most severe cases of market dealers experiencing liquidity problems were relieved by fortuitous and external measures: in one case by financial assistance from an overseas associate, in the other by a large advance provided by a trading bank in unusual circumstances. It is remarkable that these strains on the short-term money market in February 1971 were produced by a company which had first entered the market as a sizeable borrower only five months before its collapse. In that short time, Mineral Securities became the heaviest borrower in the market. Our inquiries lead us to conclude that very few, if any, of the professional lenders had a clear idea of the growing scale of its total borrowings or of the transformation of its balance sheet position and gearing of debt to shareholder funds.

If the volte face in the profit statements of Mineral Securities had not fortuitously brought its activity to an abrupt halt, a few more months could have considerably expanded the dimensions of its drawings and the exposed condition of the money markets. We also note that the three most heavily committed, and discomforted, lenders to Mineral Securities were money market companies which were associated with, and in some cases controlled by, share broking firms, and further that each of these broking firms had received large amounts of brokerage commission business and revenue from Mineral Securities' final wave of intensive share buying in the latter months of 1970. The associated money market companies lent Mineral Securities many millions of dollars to buy and bid up the prices of shares in a process that gave agency revenue to brokers who were directors of the money market companies. The euphoria from the broking profits evidently induced sanguine attitudes in the linked companies by a process with which we have become familiar from other parts of our hearings in this inquiry. So far from having internal checks on its lending impulse, the money market, through the broking associations, had some inbuilt forces of acceleration.

A number of witnesses, in referring to the psychological value of the consortium's offer of standby credit, said that it 'could be taken as a sign that 'something was being done' to control the situation. In reality, anything which was being or to be done was left to the liquidator and his assistants. The liquidator was left to make decisions on priorities and relative responsibilities and to exercise his ingenuity to achieve his objectives, in a situation that prominent businessmen considered to be of national significance.

Mineral Securities' Gamble in Financial Structuring

Part of the heavy share purchasing made by Mineral Securities during the last four months of 1970 was for the purpose of joining with Castlereagh Securities Ltd, a company associated with the Sydney broking firm of Patrick Partners, to obtain a major interest in the Nabarlek uranium deposit in the Northern Territory and an interest also in the Queensland coal deposits of the company Thiess Holdings Ltd.

The shares to be bought in order to obtain an interest in Nabarlek were those of Queensland Mines, owner of the deposit, or Kathleen Investments Ltd, which had about a 51 per cent majority of the shares of Queensland Mines. Other companies and groups, including some financial institutions, also began to buy these shares on the strength of the company's official reports. These were to prove to be grievously unprofessional, being based on inadequate testing, and misleadingly optimistic (aspects of the Nabarlek reports are discussed in the previous chapter). But Mineral Securities was especially noteworthy in its enthusiasm because of the scale of its buying and its recognised expertise in technical mining matters.

Mr McMahon told the Committee: 'Both companies [Queensland Mines and Kathleen Investments] were in the Patrick stable, and it followed that Mineral Securities dealt with Patrick Partners for the purpose of acquiring shares' (Ev. 1190). After a meeting of senior representatives of the two groups, it was decided that they should jointly seek a controlling interest in Kathleen Investments, since the key to control of the uranium deposits lay with that company. Patricks were authorised to buy on behalf of the joint venture, which was originally known as Mincast Holdings Pty Ltd and was later planned to become a public flotation under the name, first, of Castlemin Ltd and subsequently of Power and Resources of Australia Ltd (PRA). In the more advanced stages of discussion, a purchase of shares in Thiess Holdings Ltd also became part of the program.

To purchase shares in Queensland Mines was not a part of the PRA Project (Ev. 1250). However, Mineral Securities concurrently bought shares in Queensland Mines for itself at a total cost 50 per cent greater than its purchases of Kathleen Investments, according to figures supplied to us by Mr Jamison, (letter of 13 December 1971, Committee Document 14-5). In the period from 1 July 1970 to 8 February 1971, the cost of Mineral Securities' net purchases of Kathleen Investments was about $11 million, while the cost of its purchases of Queensland Mines was $16.5 million. These figures do not include large purchases made at the same time by other companies in the Minsec group. Again concurrently with these huge commitments, Mineral Securities was buying large amounts of other shares, including those of Robe River, at a net cost of about $10 million.

A motive for Mineral Securities' buying of uranium shares is suggested by a passage in Mr Nestel's evidence which we have quoted previously, when he referred to the expectation that big share-trading profits could be made from re-selling these shares after the PRA project was announced, in the pattern of Mineral Securities' trading in the shares of other associated or subsidiary companies. Mr Nestel said: 'Our view was that by taking profits in Robe River in 1970 one was going to take a lot of profits in PRA and the Nabarlek situation in 1971 ... That was our thinking at the time' (in camera). It has been seen how Mineral Securities' experience in share-market trading had turned heavily adverse in the latter half of 1970. The directors may have been spurred by the hope that a big turnover on the uranium shares in the first half of 1971 might retrieve the situation before the end of the financial year.

In the Committee's hearings after the collapse of Mineral Securities, two of its directors, Messrs McMahon and Nestel, criticised their former partners in the PRA venture in forceful terms, claiming that the behaviour of members of the Patrick group had contributed substantially to the failure of Mineral Securities. They alleged, first, that after a member of the Castlereagh-Patrick group had given them to understand that his group would arrange to obtain as much as $55 million of loan funds for Mineral Securities, this was not done; and secondly, that Patricks had prevailed on Mineral Securities to defer revealing to other parties that it was buying into Nabarlek, thus making it impossible for Mineral Securities to negotiate elsewhere for the funds to finance the share purchases. The senior partner of Patricks, Mr Dowling, appearing before the Committee in order to reply to these allegations, denied the factual substance of them and in turn criticised the financial policies and financial assumptions of the directors of Mineral Securities.

A difficulty in the way of accepting the claim that a broken understanding regarding $55 million financial accommodation was a major cause of the failure of Mineral Securities arises from an examination of the company's internal documents. Since our access to such documents was limited, the fact that we have not seen written records of Mineral Securities having ever placed reliance on the expectation of receiving this accommodation through Patricks is not conclusive. But we have evidence in the 'Financial Evaluations' memorandum prepared by Mr Nestel and his colleagues that by October 1970 Mineral Securities was not expecting finance of anything like $35 million from the Patrick group. In a balance sheet statement of 'Forecast Liquidity, forming part of this document, one company of the Patrick group, Bill Acceptance Corporation Ltd, is mentioned as being already a provider of $5 million on a '6 months rollover' basis until October 1971. It was one of three money-market companies quoted as providing such finance to Mineral Securities, the others being Ord-BT Co. Ltd for $2 million and King & Yuill Investments Ltd for $5 million. Through Bill Acceptance, the Patrick group was already, therefore, one of the largest creditors to Mineral Securities, and a footnote to Mr Nestel's list of three money-market creditors said: 'Confident that this source will continue'. In that important and extensive survey of Mineral Securities' financial proposals, that is the only reference to expected support from Patrick. When questioned on this, Mr Nestel said that the promise was 'reneged' upon 'towards the end of October' (Ev. 1544). He stated, that at the time the 'Financial Evaluations' document was prepared 'it was not realistic' to be placing reliance on Patricks for the bridging finance of about $50 million (Ev. 1541).

It is clear that there was an agreement between Minsec and the Patrick group for the provision of a loan of $5 million and the details of the terms of that loan were available to us. However, it was difficult from our examinations to form an exact impression of the period during which Mr McMahon and Mr Nestel claimed to have held expectations of a far larger loan; it was also difficult to gain any details of the nature and terms of the additional financial accommodation they had in mind. When the matter was pursued with Mr McMahon at one stage in the hearings, he said: 'In retrospect, we may have been kidding ourselves. I have thought about it a lot' (Ev. 1251). At another point, when he was asked whether the senior partner of Patricks, Mr Dowling, had ever confirmed 'in any way that his group could find $55 million for you or any other sum', Mr McMahon said: 'Not to my knowledge' (Ev. 1254). When Mr Nestel was asked whether he knew of any documents which showed or referred to an agreement by Patricks to provide about $30 million of bridging finance, he said that he could not be certain of the answer because the records of Mineral Securities were in the hands of the New South Wales Government inspectors (Ev. 1349).

The fact that the witnesses were not able to support their allegations by reference to any document or memorandum and that, at any event, the company's records were not available to the Committee, led to our decision not to pursue further this matter of the alleged $35 million credit from Patricks. The point we do wish to make is that for two or three months Mineral Securities pursued heavy share buying on short-term credit in the knowledge that there was no reasonable expectation that a $35 million loan would be forthcoming from that source. The value of net share purchases (that is, the excess of purchases over sales) made in October 1970 was $11.1 million, and in November and December $9.7 million and $7.1 million respectively, making a total of $27.9 million for the period, superimposed on the net purchases of $23.8 million which had been made in the month of September. The buying in those latter months of 1970 was in several respects the most significant of all because of the already over-stretched condition of Mineral Securities' finances.

The Hill Samuel Report

Significant evidence relating to the hazardous methods of financial structuring followed by Mineral Securities is to be found in the contents of a report that the merchant banker, Hill Samuel Australia Ltd prepared at the company's request late in 1970, and in the company's reaction to the report. Hill Samuel was commissioned to examine the scope existing for Mineral Securities to 'formalise' its borrowings, by obtaining medium or long-term finance of the order of $30 million to replace its heavy reliance on the short-term money market. The report was dated 11 December 1970, and some of the issues raised are of wide and lasting interest for the operations of corporate conglomerates and for a consideration of the interests of shareholders of member companies in such groups.

Since Hill Samuel Australia Ltd was the local subsidiary of the prominent London merchant bank of Hill Samuel, it could not be considered an unfriendly adviser to Mineral Securities. As we have noted, one of the partners of the London parent bank, Mr J.B. Alexander, was a director of Mineral Securities, and his bank had encouraged its clients to invest substantially shares of some of the Minsec group of companies, including Robe River.

At the beginning of its general comments, the Hill Samuel report raised the issue of the dual character of Mineral Securities Australia Ltd as being both a share trader and a holder of investments in'subsidiary-controlled and long-term' companies. It said:

We believe that this combination within MSAL of share trading and other activities may mitigate against the acceptability of MSAL as a borrower. Rather than regarding share trading as a potential source of cash flow with which to support debt payments, medium to long term lenders will tend to view this activity as being one which may at any time and in certain market conditions lead to operational losses which in turn could prove prejudicial to debt servicing and the overall strength of the borrowing vehicle. This attitude is perhaps supported by the experience of MSAL in the early months of the current financial year prior to the realisation of substantial trading profits in Robe River Limited ...

After developing this theme, Hill Samuel raised as a second problem 'the presence of outstanding minority share-holdings in the companies in the Production Group'. Whether Mineral Securities itself sought to borrow against the security of the assets or the cash flow of the mineral producing companies, or any producing company borrowed for on-lending to Mineral Securities, the report said, 'there would appear to be no way of showing that the borrowing arrangements had been made in such a manner that the interest of the minority shareholders were benefited - or at least not prejudiced - by the transactions.' If Mineral Securities raised funds for the development of a new wholly-owned project against the assets and cash flows of its mineral producing subsidiaries, 'the future benefit of the transaction in earnings per share will accrue entirely to the Ordinary shareholders of MSAL. The Production Group members, having charged these assets to support the MSAL borrowing, would be in the position of having a sharply reduced potential for raising finance for their own individual expansions. The future benefits of the borrowing potential would effectively have been "transferred" from the Ordinary shareholders of the Production Group member to the Ordinary shareholders of MSAL ...,

If this type of transaction was contemplated, the Report said, it should first be ratified at an extraordinary general meeting of the shareholders of each producing company, with Mineral Securities not voting. Further, since Mineral Securities acted as banker for the group of companies, the same comments would have to apply to any practices where cash flows generated in the producing companies were on-lent to Mineral Securities. Hill Samuel concluded this part of the discussion by pointing to the practice of other Australian mining groups as generally avoiding or providing against conflicts associated with borrowing from or against the assets of subsidiaries with outside-held minority equity interests.

From these two broad lines of approach, Hill Samuel drew the inference that 'the potential for MSAL to arrange formalised medium to long-term indebtedness under its present structure must be regarded as extremely limited'. So long as the group structure remained, the report said that a medium-term debt level of $10 million to $15 million was the maximum that Mineral Securities should undertake, while short-term borrowings should not exceed $10 million.

These figures compared with a net indebtedness of $55 million estimated to be actually existing at the time of preparation of the report. Hill Samuel went on to estimate that: 'MSAL is currently supporting consolidated assets probably in excess of ~130 million (allowing for the whole of the equity capital of Robe River) on a net equity worth of an amount in the region of $14 million... Taking the unconsolidated position, it seems that after netting all current assets against current liabilities, gross assets represented by investments costing $89 million are being supported by net tangible assets available for Ordinary shareholders of about $33 million.' Again, the report said, these ratios were 'very much higher' than those applying in other comparable mining company groups.

From this point, Hill Samuel introduced a note of urgency and concern into the discussion. While its analysis was pointing to the need for a large injection of additional equity capital into Mineral Securities, the report observed that it was probably 'unrealistic to expect any rights issue of Ordinary shares to be completed prior to next May', because offers of an equity share exchange with the minority shareholders of Aberfoyle Ltd, Cudgen R.Z. Ltd and Consolidated Rutile Ltd were currently being made. Hill Samuel emphasised its concern that liquidity troubles could overtake Mineral Securities in the intervening six months. The unavoidable delay in completing a rights issue would leave Mineral Securities with 'the possibility of having to meet unfunded commitments to the tune of $32 million ... until towards the end of its current financial year'. The report then described the peculiar nature, as well as extent, of Mineral Securities' dependence on the short-term money markets after a period when such borrowings had been relatively easy to arrange~ but when the climate was now changing. It said:

This commitment [of $32 million] is currently being financed in a period of easy liquidity through the inter-company and unofficial money markets, with call borrowings (including amounts owing to brokers) of $21.3 million outstanding, term borrowings of $9.7 million due for repayment by 51st March 1971, and further term borrowings of $2.5 million due for repayment during the period between April and June 1971.

On the basis of its current exposure, MSAL is probably the biggest user in Australia of the inter-company and unofficial markets with the exception of financial institutions and intermediaries. Moreover, whereas MSAL is currently using these markets to finance permanent or long-term investments in addition to trading situations and with no recourse to standby facilities, the majority of users in this area do so principally for seasonal or other working capital requirements and with the greater part of their outstandings backed by bank overdraft or other credit arrangements which can be utilised should the flow of funds through the inter-company or unofficial markets cease to be available. In addition, the greater number of companies using the inter-company or unofficial markets on an informal basis do so only to an extent where their liabilities in this area represent a very small percentage of their net worth. In contrast, MSAL's exposure in this area is equal to approximately its total unconsolidated net assets available for Ordinary shareholders and some two and a half times its consolidated net worth.

It is widely expected that there will be a period of tight money between March and June of 1971. In these circumstances, and having regard to the facts set out above, we would feel that MSAL was extremely vulnerable to severe pressure both from a shortage of available funds in the inter-company and unofficial markets and from much greater competition for these funds through borrowers who are traditional and accepted users of this market.

For these reasons, Hill Samuel pressed for a series of immediate measures to reduce Mineral Securities' reliance on short-term funds by at least $20 million. The measures included: a selling of Mineral Securities' holdings in its two associated mutual funds, even though 'this could cause some difficulty within the Group'; the completion of the PRA proposals to transfer the holdings in

Kathleen Investments to that public company, and release cash to Mineral Securities; the further reduction of Mineral Securities' holdings of shares for trading purposes. These measures would still 'leave an exposure of around $8 million to the unofficial and inter-company markets', an amount which Hill Samuel considered to be 'the absolute maximum which should be envisaged'.

The gravity and extreme delicacy of Hill Samuel's assessment of the immediate situation is most vividly conveyed in the next section of the chapter. This explains why Hill Samuel had decided not to attempt to put together a syndicate of money market operators and merchant banks to provide Mineral Securities with definite financing commitments 'minimising unformalised market exposure during the second quarter of 1971'. After noting that Mineral Securities had already arranged bill finance of $15 million extending into September 1971, the report said this amount was 'substantially more than could be made available through these markets to the great majority of substantial commercial and industrial companies'. It continued as follows:

If we were to set out to form a syndicate to provide additional facilities for MSAL we think there would be a distinct danger that, as it will be necessary to reveal full information regarding MSAL's current position and commitments, its very great temporary dependence on the market might become widely known and discussed with the effect that its own operations in this area could be prejudiced. On balance, we think it best that MSAL pursues market opportunities for formalising finance through its own best endeavours and on the basis of being able to select any parties to which it gives information regarding its position on the footing of specific inquiries made and the identities of the persons concerned.

The implications in this passage are that Mineral Securities had managed to borrow so much from the money markets because of a general unawareness of the total scale of the company's drawings; that any publication to the money market generally of the facts of the company's balance sheet would reduce the finance available to the company rather than contribute to an increase; and that for the time being there could be no retreat from the already determined course of raising money on a piecemeal basis, supplying information to a minimum of people.

Looking beyond the problem of negotiating the next six months, Hill Samuel recommended that Mineral Securities should abandon the idea of issuing convertible preference capital which was favoured by some directors but should lay plans for a rights issue of ordinary shares to yield between $25 million and $30 million. In an extensive discussion of the group's long term structure, it argued the case for a single holding company to take over all the share capitals of the mineral producing companies. Such a company, it said, would command high status for borrowing and for capital raisings by placements and rights issues. It would be a proper and enduring vehicle for Mineral Securities' production interests.

This last proposal would have spelled the end of Mineral Securities' deployment of mining subsidiaries for share market trading purposes. Hill Samuel, in fact, at the end of the report proposed a drastic reduction in the size of the share-trading portfolio and hence, by implication, in share-trading activity. It suggested that Mineral Securities had reached a scale where too much could be at risk in its speculative activities. 'We believe', it said 'that MSAL stands to "lose" substantially more through incurring market losses than it would gain by earning similar profits. We feel at this stage of MSAL's corporate development the risks of market losses should be an important consideration ... In evaluating MSAL, most institutional investors will simply ignore share trading profits as a maintainable source of income ... However, if MSAL were to declare share trading losses its market rating would also certainly, although somewhat illogically, be lowered ... The future growth of MSAL is liable to rest on production or other cash flow producing areas as opposed to the share trading market. We feel that it would be highly unfortunate if misfortunes in the market were to inhibit MSAL's growth potential in other areas'.

Reactions to Hill Samuel Report

In the margin alongside the last quoted passage of the report, Mr McMahon wrote a comment and two questions: 'Obviously not happy with us. Will HS - London know. Will potential "funders" know.' Since the parent Hill Samuel company in London had a director on the board of Mineral Securities, the significance of the first question is obscure. Mr McMahon's more general comment, written on the front page of the report for consideration by his colleagues was: 'Rather a frightening document - but what we need to make us think. However we should study situation, make up our minds correctly and quickly and move fast and definitely.'

Mr Nestel, in a memorandum prepared for a board meeting of Mineral Securities and dated 29 December, made submissions which for the most part differed from those of Hill Samuel. He said he was still strongly opposed to a rights issue of ordinary shares, for the following four reasons:

(a) Issues of ordinary shares could be best reserved for acquisitions of increased equity in subsidiaries.

(b) Premium issues to shareholders would be out of keeping with our history of generosity.

(c) Real concern that we could be vulnerable to a takeover at this critical time of our development as a mining house, should a largish issue of ordinary shares both weaken the market of our ordinary shares still further, and make too many of these shares available to a would-be buyer.

(d) The market would weaken further on the announcement of a premium issue of ordinaries, thus jeopardising the success of our bids.

Instead of the equity issue, Mr Nestel pressed for an issue of preference shares to raise $16 million. A second proposal was that Mineral Securities should reduce its current liabilities by $10 million, of which $2 million would come from a reduction in its share-trading portfolio and $3.5 million from the redemption of its share holding in the two mutual funds and another $3.5 million from a sale of Kathleen Investment and Thiess shares in excess of its Mincast subscription.

Mr Nestel's third proposal was for renewed negotiations to obtain very large external borrowings. At the end of December, therefore, he was still pursuing with an air of confidence the 'formalising' of a great part of the company's borrowings, and perhaps even more than $55 million. After Hill Samuel's recent dismissive remarks, he indicated in his report to the board that potential raisings of amounts totalling $69.5 million for Mineral Securities were being seriously considered by five financier groups, the periods of the loans under discussion ranging from one to ten years. This passage in Mr Nestel's report of 29 December 1970 reads as follows:

The following merchant bankers, banks etc. are actively looking at individual proposals, generally with scrip as collateral, and possible equity sweeteners and placements as required:

Westralian International	$30m	5-10 years
ANZ Discounts	$10m	5 years
Zurich	$4.5m	5 years
R.K. Yuill Investments	$15m	5 years
Ord-BT	$10m	1 year

Ord-BT would help out Westralian International, while Patricks will help out generally, as well as underwriting PRA.

The last subject of mention by Mr Nestel was the Hill Samuel report. He suggested that the report 'be used as a basis for further discussion when Chris Castleman [Mr C.A. Castleman, at that time the general manager of Hill Samuel Australia Ltd, and author of the report] returns from holidays'. 'For my part', Mr Nestel continued, 'I found it stimulating, but it proposes philosophies significantly at variance with those that have characterised MSAL to date. On the one hand some of his recommendations can be implemented gradually, but on the other hand I strongly recommend that we press on with the proposals 1, 2 and 3 above.'

We have found no evidence of a considered examination by the board of Mineral Securities of the fundamental issues raised in the Hill Samuel report which they had commissioned. Most of Mr Nestel's proposals, including the one for a preference share issue were accepted at the late-December board meeting. These proposals involved some contraction of the eompany's over-extended condition, but the emphasis in Mr Nestel's memorandum to the board was on further large borrowings and further expansion by takeovers. In the stated reasons for rejecting the idea of an equity issue, the lure of immediate further expansion took absolute precedence over a regard for the prudential considerations and the dangers suggested by Hill Samuel. There was no acknowledgment of the comparative company statistics presented by Hill Samuel to show the extreme unorthodoxy of Mineral Securities' financial structure. Hill Samuel's prescient warning that a revelation of share-trading losses would severely damage the company's market rating did not shake the expansionist optimism of those who knew, as Hill Samuel did not, the circumstances of the shuffle in Robe River shares which was the basis for false profit claims before and after the Hill Samuel report was presented.

Concluding Remarks

This chapter has been of necessity only an outline treatment of themes in the history of the Mineral Securities group which are pertinent to the terms of our inquiry, and it is not necessary to recapitulate every issue of substance noted in the preceding pages. The distinctive interest of Mineral Securities' record in the setting of this Report is for the light it casts in three areas: on the potential influences of corporate group control on the securities markets; on associations of mutual funds with company operations in the securities market; and in the zones of contact and overlap between the activities in the securities market and in the short-term money market. These subjects have occupied most of the foregoing discussion, and we have drawn a number of inferences from them.

Corporate Group Internal Relationships

Enough has been narrated to show that Mineral Securities was a more speculative organisation and more headlong in risk-taking than investors and outside observers could have been expected to realise during its existence. We have suggested that the public's misconception arose partly from statements emanating from the board which combined counsels of caution against excessive optimism with reports of current profit performance that gave no indication of the elaborate and highly questionable fabricating processes behind the profit claims.

Another part of the suggested explanation was the public's inability to grasp that a board of directors comprising experts in several fields does not necessarily act collectively in a way that reflects the expert views or special qualifications of any of the directors. The board of Mineral Securities comprised three persons expert and with practical training in geological and mining affairs, two qualified chartered accountants and a partner in one of the world's most prominent merchant banks. To the public, such a board structure would denote a complete grasp of recognised standards, and an application of those standards, first in mineral investigations, secondly in the company's determination of profits and published statements, and thirdly in its budgeting and financial structuring, where a high degree of harmony would be expected between the board's concepts of structuring and those of the professional financiers in merchant banking. None of these assumptions was justified by events. In the arrangement and claiming of profits, the misgivings of the two chartered accountants were overruled, and remained completely unknown to the public. The mining experts on the board outdid the wildest of unskilled speculators in their rush to plunge massively into investment in the Nabarlek uranium companies on the basis of limited, and admittedly grossly misleading, information. In the financial structuring of the group, principles which were taken as axiomatic by the international merchant banking company which had a non-resident director on the board of Mineral Securities were flaunted by the board of Mineral Securities.

Nothing was as it seemed to be. The entry of Mineral Securities into investment in going mining concerns 'in the ground', so far from denoting a reduction in its share speculative activities, provided more fuel and scope for share trading. It did this in two ways: first, by giving the Mineral Securities group some new companies that might be turned to share purchasing and trading in addition to their mining activities; and secondly by giving the group control over additional mining companies whose operations, programs and public announcements could be arranged so as to confirm the parent company's dealings in their shares. By contracting the supply and pushing up the market prices of these listed subsidiaries, Mineral Securities consciously enhanced its own apparent asset backing for borrowing and further takeover purposes.

While the perception of these realities has general informative value, and not least to bodies concerned with the supervision of the securities market, it is not easy to regulate absolutely against either the loss of directors' personal identity and judgment in collective boardroom decisions or the deployment of corporate group policies for share market manipulatory purposes. It may be impossible to lay down rules which would prevent every such occurrence without burdening all companies with deadweight handicaps to movement. This is an area in which an evolutionary approach to the regulatory task would be appropriate. The circumstances described in this chapter could help to introduce more scepticism into the investing public's future treatment of professions by company directors of a firm recognition that 'it is the shareholders who own the company', for we have a reminder that the directors may in the same breath be issuing misleading statements about the company's trading experience, and the shareholders listening to the assurances may be within three months of losing every penny of their investment in the company. But if every company board's every pronouncement were to be distrusted, the situation would have passed beyond a healthy scepticism to general cynicism towards corporate and investment affairs, and we do not believe that this is necessary or acceptable. It is impossible to accept the suggestion that the main mistake, or only mistake, of the Mineral Securities directors was to fail. These can be no legislation against business errors, nor should there be, for it would be the death of experimentation. But mistakes are intolerably compounded in effect when the public is deceived about a company's affairs. Full and truthful publication would not only be a deterrent to some forms of extravagance, but gives fair warning to lenders and investors of the ventures they are invited to support.

We certainly do not think it is unduly restrictive to insist that there should be full and unequivocal disclosure in the areas under discussion. The necessity for this in profit reports does not need elaboration. It is an old truism, but still not always observed. In this administrative area where there is need to eliminate gross forms of misrepresentation without hamstringing enterprise, a regulatory body may have a number of general courses of action available to it for raising standards, in addition to the active employment of its investigatory powers and skills. The body should make itself an articulate presence in the community. It should publicly, and as often as is thought necessary, describe types of practice which it considers to be improper or undesirable, with a view to reducing the scope for tortuous debate and uncertainties of conscience in company boardrooms. It should spell out the reasoning behind its conclusions. It could address itself specifically to the auditing profession on the meanings it would apply in particular classes of instances to the words 'a true and fair view', which auditors use when certifying to company accounts. By its public statements in such matters, the regulatory body would not only invite comment and suggestions on its views but would make the issues a matter of general and continuous consciousness in the securities markets.

In the field of company conglomerates, where several companies of a group are listed on the stock exchanges, all transactions of each company in the shares of any other member companies should be a matter of public record, with details of the dates, the quantities involved and the prices. The time interval between such intra-group share transactions and the public reporting of them should be strictly limited, either by legislation or statutory regulation. One witness, Mr C.A. Castleman, the general manager of Hill Samuel Australia Ltd, suggested in evidence that the parent company of a group could be required to disclose its dealings in shares of associated companies 'on the day of purchase' (Ev. 850). We would like to see all such dealings revealed within a week. But whatever the permitted time interval before disclosure, it would be necessary to stipulate that the annual accounts of a company must include details of all such transactions it has made in the period covered by the accounts. 'Insider trading', as we have had reason to note in this chapter, has moved beyond the personal to the corporate trading level, where it can be even more misleading in its consequences. An insistence on public disclosure of intra-group share movements does not settle all the problems of potential conflict when separately listed public companies are under a single control. The transfer of assets and liquid funds between such companies can be to the disadvantage of members of the investing public who are minority shareholders in a listed subsidiary, as the Hill Samuel report pointed out to the directors of Mineral Securities. Several listed subsidiaries in that group, such as Pexa Oil and Amad, suffered grievously because their policies were subordinated to objectives of the parent company. Mr Jamison offered us other examples and some general comment on the problem. He said:

... Some of these groups where there were outside minority shareholders with independent boards - not completely independent boards - but independent directors on the boards - protested very strongly on some occasions. One particular occasion was in connection with Consolidated Rutile. But notwithstanding those protests, the majority of the MSAL members on the board of the subsidiary ruled that the money be paid over ...

Senator Rae: ... Would you be prepared to comment as to whether you think Mineral Securities, insofar as it has held the control of the subsidiary companies, exercised that control with a proper regard to the interests of minority shareholders?

Mr Jamison: I would say it took no account of the interests of the minority shareholders.

Senator Rae: That is a considered statement.

Mr Jamison: Yes, with now a qualification that it possibly thought that it was protecting the interests of the minority shareholders by doing what it did.

Senator Rae: In other words, whatever I say is best for you.

Mr Jamison: Yes.

(Ev. 2988-89)

It is clear that once this involvement of a subsidiary develops,

a further deepening of the involvement may be rationalised as necessary action to protect the subsidiary's interests: that, for instance, a collapse of Mineral Securities could (as it did) bring heavy losses to the market value of shares held by the public in its listed subsidiaries and mutual funds, since the holdings of similar shares by the parent company would have to be sold up. On such arguments, good money may be sent after bad, and those having the power of decision may not be in the best position to make objective judgment in the subsidiaries' interests

We do not pretend that there are tidy remedies available to provide against this kind of danger. The Hill Samuel thesis that public minority holdings in subsidiaries are to be eliminated as much as possible is sound, yet it would probably be going too far to decree that there shall be no subsidiary companies on the stock exchange lists or that one public company may not buy more than a set proportion of another public company's shares in the market. The existence of a statutory body to monitor company affairs would not automatically eradicate the risks, as recent experience has shown. An intelligently active body may, however, reduce them if it exercises its powers of investigation with some special attention to the affairs of associated listed companies and publicly reports its factual findings in cases where publication seems to be warranted.

Relationships with the Mutual Funds

Another of the conclusions of this case study is that conflicts of responsibility such as existed in the conduct of the Minsec companies and the Minsec mutual funds are not merely a matter for occasional unease or faint disapproval. They require vigilant and active surveillance on their own account, and we believe that these conflicts should be subject to specific limitations and prohibitions in certain areas. They can, and do, make a mockery of the purported working processes and administration of the securities markets. No elaborate legal formulas prescribing procedural checks and balances can withstand the destructive forces that are to hand in a group where there is a determined and resourceful combination of multiple functions.

We consider it is a matter for special concern that proper standards should be established for the conduct of collective forms of investment such as the mutual funds, where some of the least knowledgeable members of the public are invited to place their money with assurances of protection from risk. The examples of the Minsec-sponsored mutual funds show how easily, in present circumstances, such bodies can be made to serve outside interests at heavy cost to the public subscribers. In the process of establishing more satisfactory standards for mutual funds, one of the necessary first steps will be the containment by regulation or statute of future dangers arising from conflicting responsibilities. The Minsec record obviously does not establish a case for saying that the directors or managers of mutual funds should be barred from holding any directorships in other companies. It does establish a case for saying that there should be no overlap in memberships between the board of a mutual fund and the boards of its attendant companies, and for saying that within the boards of the mutual fund and of the attendant companies there should not be a concentration of representation from any particular outside group such as existed in the Minsec construction. We believe these suggestions are minimal, and that more should be done both to protect and promote forms of collective investment such as mutual funds which are a relatively neglected field in Australia. We turn to some of the wider aspects of the subject in an appendix to this chapter.

The Case for Supervision of the Money Markets

The Minsec evidence has revealed clearly how there is a close interrelationship between the short-term money markets and the share market, and we have seen how, in the final stages of the mineral share boom, very large sums of short-term funds were being drawn from major Australian companies and used to finance massive speculative dealings on the stock exchanges. In our view, the Commonwealth and State authorities have failed to inform themselves of the practices and activities in large sections of the money markets, arising partly from the attitudes of the Reserve Bank. We therefore conclude this chapter with a brief examination of the case for additional supervision of the money markets.

The Australian short-term money markets have grown to their present substantial (though so far largely unquantified) scale in a short time, having played a relatively insignificant role among the financial intermediaries until the late 1950s. There is no obvious reason for expecting the future growth rate to fall away. Large sections of our money markets dealing in non-government securities do not come under the purview of the central bank. At the same time, we have mentioned evidence to suggest that a relative lack of experience and tradition in our markets may entail some laxity of standards and care in the handling of such big money transactions.

Intervention is not to be sought for intervention's sake. Fluidity, speed and informality are the essence of the arrangements for short-term lending of big money balances. Red tape could strangle activity that is legitimate, and although it may not rank as one of the more essential activities in our society, the short-term money market helps to promote efficiency in the use of resources. These markets are also tapped as a source of funds for government finance, and they can be an effective medium for the transmission of official monetary policies in the management of the economy. There appears to have been a good illustration in May 1970 of the additional leverage that the markets can give to official policy. The authorities' success in tightening credit at that time was quicker and more decisive than on some previous occasions, and it seemed this was largely due to the impact of the measures on the 'unauthorised' as well as 'authorised' sections of the short-term money market.

An examination of the case for a degree of official surveillance of the money markets is not intended to imply a suggestion for governmental underwriting due to the misjudgement or recklessness of the borrowers in the markets or the imprudence of lenders to them. To convey an impression that the government might be 'featherbedding' transactions in the markets could promote greater carelessness and involve governments in introducing an increasingly elaborate network of regulations. It was largely on lines similar to these that the Governor of the Reserve Bank and the Chief Manager of the bank's Securities Markets Department, in evidence to the Committee, explained the Reserve Bank's reluctance to involve itself in the affairs of the 'unauthorised' money markets. While referring also to the legal limitations on the powers of the Reserve Bank, they conveyed an impression that they did not desire to have an extension of powers in this direction.

The propositions which we have just expressed are unexceptionable in themselves and we repeat that we accept their relevance to a discussion of the future conduct of the money markets. We believe, however, that a realistic and adequate consideration of the issues involved has to go further. We have not found prima facie grounds for assuming that a change from one extreme of having no surveillance of these markets must result in the opposite extreme of having too much interference. Official interest in these markets could in principle at least, fall well short of any commitments to bail financiers out of the consequences of their mistakes, and this intention could be made plain to those concerned. It is not only the incompetent or culpable professionals who may be put at hazard from events in markets where great sums of money are daily transferred at short notice and on very short-term loan. Because these markets are naturally quick conductors, liquidity problems can be transmitted through them with speed and cumulative force. While an original defaulter in his debts may not deserve sympathy, and his direct creditors at first remove may deserve little more, there is a point where blameless parties may be caught up in the repercussions. Altogether beside the question of subsidising the losses of anybody who is affected, there is a need to ensure in the general interest that the assets of a big insolvent defaulter in the money markets are sold at better than panic selling prices. This may require a measure of temporary financial accommodation for an orderly liquidation of assets, covered by a realistic evaluation of them. Early action to provide this may have useful psychological effects. The instincts which prompted a random, heterogeneous group of large companies, in the first place, to conclude in February 1971 that something should be done to watch for and, if necessary, control the potential repercussions from the collapse of a large short-term borrower were in principle sound instincts, and, we believe on the evidence, applicable to the circumstances of that particular contingency. If that much is accepted, it may well follow that the 'something' should not best be left to a possible chance assembling of business groups having no direct interest in the affairs of the failed company, or any prescribed responsibility to act, or, perhaps, expertise for assuming such a role.

The issues go beyond the need for some defined responsibilities in a time of emergency. Prevention is more durably constructive than cure. The scratch team of companies which came together at the time of the crisis in Mineral Securities soon afterwards dissolved as an organisation, as was to be expected. One Commonwealth Government institution, the Australian Industries Development Corporation, participated in the consortium after its chairman attended the discussions at Kirribilli House, and in its first annual report published nine months later the corporation indicated why it considered that the circumstances had required it to act. 'Because of the widespread implications of Minsec's collapse', the report said, 'the situation was one of near-crisis in Australian securities marketing and a threat to Australia's investment image abroad. Accordingly, AIDC joined in a consortium of Australian banks and major companies, whose prompt action in offering finance to Minsec's provisional liquidator helped to allay fears and to enable the situation to be stabilised.' The report also said that the Australian Industries Development Corporation had been motivated by a desire to preserve Australian ownership of the major assets to be liquidated, but in this objective it had acknowledged failure. 'It is evident', the report continued, 'that overseas groups seeking a base in the Australian mineral industry, or seeking a producing company to complement their exploration activity and better their taxation position, will base their bids for Australian mining assets on a standard of valuation which contains other elements besides the financial assessment of the ventures themselves.' Interesting as the viewpoint and action taken by the Australian Industries Development Corporation are, this body has not been designed or commissioned to keep an eye on the money markets, and quite apart from considerations of etiquette in its relations with other Commonwealth institutions, it should not be expected to move into such a continuing role.

If there had been an official monitoring body in existence, it seems likely that it would by now have given thought to practices where money-market companies which are closely associated with brokers are persuaded or induced to finance heavy share purchases by clients of the brokers, yielding commission to the brokers, but ultimately compromising their own solvency as well as that of the money-market companies. The body could well have investigated the quantitative extent of such relationships and considered whether there was a need to eliminate or reduce this zone of potential conflict in responsibilities - a zone also of overlap between the activities of the money market and the securities market. Such a body could well have considered the pertinent question arising from the case of Mineral Securities as to whether borrowers and intermediaries in the money market should be prevailed on to supply updated balance sheet information at more frequent intervals than they have been doing. So far from carrying implications of a governmental commitment to underwrite mistakes made in the market, the advice and warnings conveyed to the operators could leave them with less ground than before for claiming a right to be bailed out of the consequences of a disregard for standards.

Routine inquiries of the kind we have indicated by example would be in the direction of rational development. They would not impair the essential freedom and efficiency of the money markets, but would promote sound practices. In Britain and the United States, the official element in such a procedural arrangement is supplied by the central banking authority. Alternatively, an official connection with the money markets might be exercised through a national supervisory body for the securities markets. If necessary, this could be a matter for discussion between such a body, when established in Australia, and the Reserve Bank.

It may be suggested that any other body would have one advantage over the Reserve Bank in a supervisory role, in that it could not even appear to be a potential supplier of finance to the 'unauthorised' dealers. If a firm decision were taken that they should not enjoy 'lender of last resort' facilities, this could be a consideration. Meanwhile, it is to be noted that a number of the persons representing the 'authorised' dealers in the money market, who have frequent contact with the Reserve Bank in that capacity and are subject to its supervision, are also persons holding similar positions of active engagement in the 'unauthorised' sections of the market. This fact would make it relatively easy for the Reserve Bank to extend its area of interest and associations with a minimum of formality. Admittedly, it could involve the Reserve Bank in sustaining a different set of standards of supervision and formal commitment as between the two sections; the risks of confusion in this regard are to be set against the possible alternative of having two different official bodies negotiating with money-market companies which are engaged in associated activities, have identical ownership and are sometimes staffed by the same persons.

We have already noted that the 'unauthorised' money market has a growing role in giving effect to the Reserve Bank's money and credit policies, but the Reserve Bank range of interest can also be said to impinge at other points. For example, one of the 'unauthorised' segments, the inter-company lending market is known, from discussions with operators in that market, to have been affected by movements in the size of the unexercised bank overdraft limits held by inter-company borrowers from time to time. Borrowers have used their unexercised limits with the trading banks as a form of quasi-security or backing to obtain their short-term accommodation in this money market. It follows that developments in sections of the 'unauthorised' markets can have a bearing on the rate of trading bank lending through the exercising or non-exercising of overdraft limits. Nevertheless, our hearings of evidence revealed that the size of the inter-company lending market was not known to any authorities, or to the operators in that market. The $70 million of market funds which was suddenly withdrawn and locked away from the 'unauthorised' money markets in February 1971 could not be related to any reliable estimates of the total funds outstanding in those markets. Statistics appear to be available for every substantial sector of financial intermediation in Australia except this one. The Reserve Bank collates and regularly publishes volume figures for the 'authorised' section of the money market. Without similar data on other sections which co-exist and have interflow with the 'authorised' sections, the figures have restricted usefulness. Nothing is known quantitatively about relations between these markets or trends in the money markets taken as a whole, including the significance of such trends for activities in the older financial intermediaries, though it is evident that the importance of the intermediaries over which the Reserve Bank has traditionally exercised supervision has diminished as a proportion of the total financial sector of the economy. Likewise, there is no information on the financial inter-relationships between the trading banks and the securities markets through brokers' overdraft. We believe that the collection of statistical information from the burgeoning money market would not necessarily commit the collector of information to shouldering all the responsibilities or sharing all the problems of those markets. The absence of information is as unsatisfactory as it is extraordinary.

We would expect a national supervising authority over the securities markets when established~ to examine this regulatory no-man's-land (assuming that it remains so), and then proceed to discussions with the Reserve Bank and Treasury before arriving at a decision as to which body will extend its interest into the area. We would not expect them all to avoid the issues. Some recommendations on this subject are contained later in the Report.

APPENDIX 1

SOME COMMENTS ON COLLECTIVE FORMS OF PUBLIC EQUITY INVESTMENT

It has been shown that the disgraceful investment records of the two mutual funds, the First and Second Australian Growth and Income Funds, in the period of barely a year when they were controlled by Mineral Securities arose mainly from ways in which they were used as instruments to further the expansive ambitions or protect the interests of the corporate group that sponsored them. An even more disastrous case of personal losses resulting from a mutual fund's association with a speculative corporate group was to be seen in the contemporary record of the funds sponsored by the Trendex companies (see Chapter 12).

While these are extremely gross instances of the subordination of the welfare of public subscribers to collective forms of equity investment to the interests of particular business groups, and are exceptional in the severity of the losses inflicted on the subscribers, it is by no means uncommon to find that collective forms of investment in Australia are linked to the fortunes of associated corporate groups, and contribute to the financial resources of the groups for various objectives. A number of the property trusts in this country, though not all of them, are linked with real estate development companies. Again, we have noted that the Tjuringa Securities group, in its speculative battle with the short sellers of shares in Antimony Nickel N.L., called upon the mutual fund which Tjuringa had sponsored to supply part of the money sunk into the contest; while Tjuringa took steps to provide indemnity against loss for the mutual fund in this exercise, the protection was only as strong as Tjuringa and the expected profits were mainly to go to that company. We would never expect an independent mutual fund to lend large amounts of money for such purposes.

Apart from risks of outright loss, the positive earning ability of mutual funds and other types of collective investment is liable to be compromised when the effective controllers of the funds have other predominant interests and have the power to enlist the resources of the funds for the advancement of those interests. The unit trust movement appears in recent years to have been largely protected from this form of corrosion by State legislation requiring that they operate with independent trustees and that one of the prescribed covenants of the trust deeds declare investment in or loans to the managers of the unit trusts or related companies. Some unit trusts and some investment companies of the management type have turned in creditable results for investors, yet it is apparent that, by comparison with European and British countries, the popularity and the growth of collective forms of share investment generally in Australia have not been impressive. The unit trusts, having shown pronounced growth in the 1950s, failed to maintain it subsequently. For many years, they have been regular net sellers of company shares (their sales have been exceeding purchases, generally by a large margin) and they have turned for business to the promotion of real estate unit trusts. This switch has been accelerating. Returns of the Commonwealth Statistician show that in the six years ended June 1973 the combined activities of unit trusts, land trusts and mutual funds produced an excess of sales over purchases of company shares amounting to $84.6 million, and that in the last half of calendar 1973 the excess of sales over purchases was proceeding at an annual rate of about $14 million. By contrast, the six-year record of these various forms of collective investment in the field of land, buildings and mortgages shows an excess of purchases over sales amounting to $145.8 million, and in the second half of 1973 it was running at an annual rate of more than $87 million. There has been a continuing, though relatively small, net investment in company debentures and notes, amounting to about $31 million over the six years to June 1973.

When Mr Ronald Ashton Cox, a senior manager of Australian Fixed Trusts, the largest of the unit trust groups in Australia, gave evidence to the Committee in December 1970, he attributed the change in direction of his group's investment policy largely to the climate of public preference. Mr Cox said:

I think it gets back to two things, our inability to attract the public by way of advertising to invest in equity shares, probably linked with perhaps the public's reluctance to invest in them at the present time anyhow, but more particularly because the moneys we receive from the public now are from people who are looking for income with capital growth. I can only give them those two commodities with the property and mortgage trusts. At the present time I cannot give it to them with the same security in an equity share trust as I can in the other types of trust.

(Ev. 790)

Mr Cox testified that investors in his unit trusts are generally white collar workers aged 45 years or older, and that between 40 per cent and 50 per cent of them are married women (Ev. 795). They appear to be people who combine a wish for security with awareness of the inroads that inflation can make on savings and a desire for a measure of participation in national growth. If they are inexpert as investors, they are a class of people who could not be considered unintelligent or unobservant.

Part of the collective trend into real estate investment undoubtedly reflects objective circumstances of prolonged buoyancy in the property markets as well as differences between at least the immediate income from rents and mortgages and the lower yields obtainable from leading company shares. But the degree of outright contraction in share holdings is hardly explained by the attractions of the property boom alone. Another part of the explanation, as Mr Cox's evidence implies, seems to be the general reputation of the share market after disturbing events in recent times. Yet another part could well reflect the unhappy performance records of some instances of collective investment itself, ranging from the losses caused by simple misjudgment, or even a misplaced sense of prudence (a notable past example being the tendency of some unit trusts to invest heavily in Government bonds and other fixed interest securities when interest rates were about to rise and the market value of ~he securities correspondingly to fall), and on to cases of reckless irresponsibility shown by the managers of some mutual funds. Not all of the recent swing to property investment as the only accepted growth avenue for collective savings can be regarded as a healthy sign or as being socially desirable. To mitigate any excesses of it, however, will require a steady and soundly based process of restored confidence in the conduct of the securities market and in the management of pooled forms of investment.

The first, overdue, task is to eliminate scope for misuse of collective investment avenues. This has been in practice a largely unpatrolled area, so that the Trendex group could, and did~ raise large sums from inexpert investors in its mutual funds without telling them in its prospectuses that they were investing in companies of unlimited shareholder liability and might lose more than the full amount they were investing in those funds. This danger was heightened by policies developed in the Trendex group of diverting money from the mutual funds to private companies of the directors: another uncontrolled practice which must cease. Even the routine 'Additional Statutory Information' appended in small type at the back of the prospectuses for Dividend Fund Incorporated and Increment Fund

Incorporated did not refer to the risks of unlimited shareholder liability, risks that materialised for shareholders of the first named fund and almost did so in the second. It would be highly desirable for everybody in Australia to be made aware of what happened to the unfortunate investors in Dividend Fund Incorporated, and it would be understandable if everybody who knew about it resolved not to invest in mutual funds. The wonder is, perhaps, that members of the public have continued to subscribe to mutual funds.

Effective supervision of the issuing of prospectuses and an insistence on the inclusion of basic information in collective forms of investment are the necessary first steps to reform. We believe that the restrictive part of the program must be taken further. As suggested earlier in this chapter, the kind of overlap of personnel in the boards and management of mutual funds or trusts on the one hand and the attendant monitoring companies on the other, such as existed in the case of the Minsec and Trendex funds can lead to impossible conflicts and should cease absolutely. We also believe there should be limitations on the degree of representation of any outside company or group on the boards of the funds or their management companies. This may mean some diminution of expertise, but the recent record suggests that loss of independence of judgment on a mutual fund's board is too high a price to pay for this type of expertise and business contact. We take a stricter view of the permissible degree of association between mutual funds and particular corporate groups than of those between listed companies.

It is an obvious corollary that substantial changes in the management and control of unit trusts, mutual funds and investment companies should be matters requiring the regulatory body's foreknowledge and consent. The control of large amounts of collective investment funds is not a proper field for indiscriminate takeovers or market 'raids' or private deals.

On the other hand, our inquiries have indicated that there may be a case for liberalising the legislative provisions applying to collective forms of investment in some respects. It has been suggested to us that there is something of an unfilled gap between the facilities offering at present by mutual funds and unit trusts. The legislation in some States tends to direct into the formation of mutual funds those bodies which desire to retain a large part of their annual incomes for re-investment and capital growth, rather than distribute them in dividends. But the mutual funds have the glaring disadvantage of being required to impose unlimited shareholder liability if they are to be free to redeem shares (that is, to reduce capital) on demand. The unit trusts, while not involving unlimited liability for investors, are less able, for taxation reasons, to retain income for re-investment. Given a proper supervision of this whole area of investment in future, it should be possible to allow greater flexibility of policy to each kind of body. With such continuous scrutiny, it may also be possible to permit more effective promotional methods for the trusts and funds than can be tolerated at present.

Although this preliminary groundwork may not be enough positively to encourage the growth of collective investment, it would remove some of the more formidable existing impediments to it. In the long run, the growth of this class of investment will be a function of the performance and the reputation for trust-worthiness of Australian share markets.

Collective forms of investment are one of the areas in which we would expect a regulatory body to set itself positive goals of development in addition to its monitoring function against unsound practices. One of the measures of such a body's overall success in promoting better securities markets will be the experience of smaller investors who turn to these avenues for their funds. As a regular reminder to itself and others of this part of its responsibilities, we would expect the supervising body, in its periodical reports on its activities, to refer to current trends and experiences in the collective investment sector. On the basis of its observations and knowledge, we would expect it to make such recommendation to governments for legislative change as it considers desirable for the sound development of this sector.

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CHAPTER 15

SUMMARY: THE FAILINGS OF THE EXISTING REGULATORS

As the foregoing chapters of the Report have made clear, this Committee is seriously concerned about the inadequacy and ineffectiveness of the present regulation of the Australian securities market, of related activities of public companies, and of the corporate managers of some investment companies and investment entities.

We discovered numerous instances of improper practices in the making of new issues, and in the distribution of previously issued shares. There has been considerable evidence of insider trading, manipulation and other abuse in the stock-markets. We have seen much evidence of behaviour among share-brokers, other intermediaries and advisers in the securities industry and among some financial journalists which has fallen short of minimum standards of propriety, competence and financial responsibility.

In addition to our concern with abuses within the securities market, we are alarmed by evidence of improper, reckless and incompetent behaviour on the part of some of those in control of public companies and investment funds. The investor has too often been exploited by controllers of listed public companies and by managers of investment funds.

We are also alarmed by the frequency and serious nature of failures to meet appropriate standards of full, accurate and timely disclosure. Many of the several hundred prospectuses we received were misleading or failed to give sufficient information to enable an investor to make reasonable judgments on the merits of a venture. Likewise we found that many companies have neglected to make adequate disclosure to stock exchanges in published accounts and in statements to the market, while others have published accounts which have been misleading or deceptive.

There is, therefore, cause for concern and for legislative action on the grounds of fairness and commercial morality, and in the interests of economic efficiency.

There is a tendency on the part of some to argue the question of regulation purely in economic terms. However, theft has been outlawed to protect individuals, not simply because of its economic consequences. Similarly modern trade practices and consumer protection laws are motivated by a desire to prevent exploitation of the individual by those with greater economic power, greater access to information or greater bargaining strength. More adequate and effective company and securities laws are required on grounds of fairness and commercial morality.

It is true, however, that the abuses which occurred during the years of our investigations resulted in significant impairment of the performance of the economic functions of the securities market. Investor confidence in the market was greatly shaken. At one point there was a serious threat to the financial stability of substantial dealers in the short-term money market and to a number of large stockbrokers associated with these dealers, while, throughout, there was considerable diversion of funds from productive to speculative ends or from the pockets of the public into the pockets of promoters, brokers and others. Such evidence provides strong support for the proposition that the economic wastage arising from present effective regulation may be greater than the cost of an improved regulatory system which reduces abuse to relatively minor levels.

It must also be noted here that securities markets will not, in the long run, develop or maintain any reasonable standards of efficiency in gathering financial savings and distributing them to productive uses in industry if those who run - and operate in - the market allow sharp and manipulative practices to develop and continue unchecked. Many institutions and individuals must, in such circumstances, be expected to direct their funds elsewhere. The basic function of a modern securities market as a meeting point between business and the general public in a democratic society must rest on standards of trust and mutual respect. Yet a long series of reports on company affairs arising from investigations by State Governments as well as this inquiry suggests that this issue of maintaining standards of corporate truthfulness is a central problem for the conduct of our securities markets.

The practices we have referred to cannot be dismissed as part of that exceptional series of events known as the Poseidon boom and, therefore, as having no implications for legislative action. Many of the promotional and manipulative techniques we observed have been well known and documented in other industrialised countries and have long ago brought forth regulatory responses by governments. Some were known at the time of the 'South Sea Bubble' in Britain in the early eighteenth century. Many of them were described by the U.S. Senate Committee on Banking and Currency's inquiry into the Stock Exchange Practices which followed the Wall Street Crash of 1929. Such evidence as is available about previous periods of high and rising activity in company securities in Australian markets suggests that similar patterns of abuse and shortcomings in disclosure have occurred before, though sometimes concentrated in other areas of the securities market. We have no doubt that, in the absence of an effective regulatory organisation, exploitation of the investor will continue, rising to serious levels whenever investor interest, conditions of liquidity and other circumstances occur and produce heightened stock market activity. Government in Australia would be irresponsible if it were not to upgrade substantially regulatory procedures so as to guard against repetition of fraud, abuse and incompetence on the scale of recent years.

In Australia at present there is no body or group of bodies which has, individually or collectively, the responsibility, the jurisdiction, the power and the expertise to ensure the adequacy and effectiveness of regulation of the securities market and related public company activities. Rather, regulation depends upon the action of a number of bodies, the principal ones being the stock exchanges and the State and Territorial Companies Offices.

We will review briefly each of these in turn.

Failings of the Stock Exchanges

There has, for a long time, been an assumption on the part of some governments, company registrars or commissioners, law reformers and others that general responsibility for regulation of the securities market rests with the stock exchanges and more particularly with their committees, and that, having regard to their performance and expertise, it is best left to them. That assumption is not warranted. First of all, it overlooks the fact that the stock exchanges have limited jurisdiction and power (Ev. 1677).

They do not have jurisdiction over many intermediaries who perform important functions in the securities markets and are not members of a stock exchange. Such intermediaries are merchant bankers, money-market dealers, managers of investment companies, trusts and funds, option dealers (Ev. 555 & 1484), investment advisers and consultants. In respect of these intermediaries, the stock exchanges do not have power to investigate failures to meet standards of disclosure to the market and manipulative or fraudulent activity in the trading of shares. Stock exchanges, might, at times, have some indirect effects on the activities and standards of these groups. This appears to have been so on some occasions when members of the stock exchanges have been associated with the other intermediaries, or when those intermediaries have sought to have new securities of companies for which they have raised capital listed on the stock exchanges. However, this indirect influence of stock exchanges has been insufficient to ensure adequate regulation.

In the case of listed companies, exchanges have limited legal powers to investigate breaches of their rules and listing requirements; they cannot inspect records within the offices of listed companies. A stock exchange may inquire of a listed company about a particular event and receive an answer, but it has no means of checking to see whether that answer is truthful or accurate. It has also been suggested that the stock exchange committees have limited legal power to investigate the financial position of members and suspected breaches of rules by them, though the question has not been authoritatively settled (Ev. Cooper, 1055). We have noted, in particular, that the stock exchanges do not have effective power to trace a member's activities through the separate corporate entity of associated companies, even when the activities of those associated companies are intimately interwoven with the member firm's activities (Ev. 533). In general, a stock exchange investigation of certain share dealings cannot proceed beyond the floors of the exchange or beyond the offices of member firms; at that point the trail stops. These limitations of jurisdiction may, in part, explain stock exchange failure to develop adequate systems of market surveillance in order to detect abuses.

Notwithstanding these limitations, the performance of the stock exchange committees has fallen far short of what they could have attempted and should, we believe, have achieved. They have not fulfilled the responsibilities which the public has expected of them. While the power of the stock exchanges to regulate non-members is undoubtedly limited, the exchanges should have assumed wider responsibility for the regulation of their members' activities as underwriters and as dealers in securities on their own account or through affiliated share-trading companies. Mr M.R.L. Dowling (senior partner of Patrick Partners) told the Committee that 'the rules of the Stock Exchange are to do with dealings on the floors as share brokers'. He went on to say that 'underwriting functions and the short term money operations, etc., are not really covered at all in the rules and never have been' (Ev. 2270).

There are two regulatory functions which have been regarded as the special responsibility of the exchanges:

(i) The regulation of their own members;

(ii) The supervision of the market itself to ensure that it is viable, orderly, fully and speedily informed, honest and fair.

Regulation of Stock Exchange Members

Dealing with the first of these, we have found that the performance by the exchanges of their regulatory responsibilities with respect to their members has been seriously wanting. The objective of that regulation insofar as it is concerned with the discharge of a public responsibility should be to ensure that members behave in conformity with the high standards of conduct and responsibility expected of professional financial agents. The stock exchanges should be doing their utmost to ensure that, when carrying out various functions in the public share market, their members are providing honest, skilled, unbiased and efficient service. The right to carry out the stock exchange function of advising the public investors should be available only to those who have demonstrated their ability to meet at least minimal standards of competence, integrity and financial responsibility. The public, including clients, other intermediaries and their clients, should be scrupulously protected against the possibility of loss caused by the financial instability of a stock exchange member. A broker's unbiased commitment to his clients' interests should not only be assumed but should be assured, and his services should be efficient and at reasonable cost.

One of the first findings of this Committee was that the stock exchanges have commonly failed to obtain or be supplied with information on market practices of their members and to use this information as a basis for the formulation of new rules and regulatory procedures (see, particularly, Mr Cooper's evidence, Ev. 1052-54). For example, the stock exchanges were unable to provide us with detailed information on the following matters which could impair the proper performance by brokers of their functions as described above.

(i) Trading as a principal, either to perform a specialist or jobbing function, for 'arbitrage', or for speculative dealing (Ev. 1523). (Well after our inquiries began, one stock exchange did begin to collect such statistics, but none of the findings has been published and we are not aware of any analysis of the data.)

(ii) The use of member firms' house accounts, particularly in respect to the activities in (i).

(iii) Share trading by members through their associated companies (Ev. 925).

(iv) The acceptance and mode of treatment of discretionary accounts.

(v) The volume and nature of short-selling where it has been permitted and so-called 'arbitrage' in Melbourne, where it is not.

(vi) 'Line-switching' or 'hotch-potch', and the abuse of these practices by members who have financed their own speculations with clients' funds or who have used clients' securities to provide liquidity for their firms' operations. (For a description of 'line-switching' see Committee Document 15-1).

(vii) The quantity of, and terms upon which, credit has been extended to member firms; the volume of, and conditions on which, credit has been provided by brokers to clients; and the effects of this receiving and giving of credit on the financial soundness of member firms.

(viii) The methods by which underwriters have distributed shares in new issues (Ev. 1674).

On the other hand, we have been interested to see that in the United States the responsible authorities, both self-regulatory and governmental, have commissioned or ordered factual, in-depth studies on many matters concerning market activities so as to produce sound regulation. In addition, these authorities have closely and objectively examined the arguments and considerations relevant to regulation. By contrast, the Australian stock exchange committees have not only failed to collect the relevant statistics on various dubious practices, but have failed to discuss the need for regulation of many of these practices (Ev. 274 & 2518).

We also found that in respect of many important matters concerning the activities of members, the stock exchange rules were inadequate. Evidence disclosed serious weaknesses in:

(i) Rules for the determination of minimum liquid capital requirements of member firms. Defects were found in the rules governing the extent to which a firm's capital could be invested in speculative assets and in assets of a type which are difficult readily to realize.

(ii) Regulation of borrowing, especially of short-term money used to finance speculative dealings by brokers and their clients (see Ev. 529).

(iii) Regulation of the relationships between the agency activities of members (executing security transactions on behalf of clients) and their non-agency activities. Several chapters of this Report demonstrate that the collapse, or threat to the solvency, of several brokers was due at least in part to their involvement in money-market functions, in underwriting, in share trading on their own account, or in the promotion and management of highly speculative companies (see also the case of Hewson v. Sydney Stock Exchange Ltd, 1968). In addition, in several of the studies, the involvement of stock exchange members in underwriting, in the promotion of speculative companies, or in very large share trading for themselves or associated companies, made it hard to see how these members could advise and act for clients uninfluenced by concurrent considerations arising from their own positions as traders (see, for example, Chapter 9, A Case of Conflicting Associations in a Run; also Chapter 3, Financial Structure and Profits of Member Firms of the Stock Exchanges). We also obtained some evidence of brokers 'tightening' the supply of shares in new issues in order to force up the market price in the 'post-issue' market; subsequently the shares retained by the brokers were sold on the market at the artificially high prices brought about in this manipulation.

(iv) Regulation of trading by employees of sharebroking firms. We heard of numerous instances of share trading by employees of stock exchange firms. Many of these employees were in fact gambling far beyond their means with the use of credit obtained from brokers. In several instances where members of stock exchanges defaulted, we found that they had suffered substantial bad debts as a result of their employees' share trading. As these firms also had large deficiencies in their trust accounts - a position which had apparently been developing for some time - we concluded that clients' funds had, at least in part, been used to finance the employees' trading. It was also revealed that a substantial volume of share trading by employees was carried out with the use of fictitious names and accounts, apparently without the knowledge of the employers.

(v) Rules governing short selling. The evidence disclosed that at periods during the mineral share boom there was a very high volume of short selling in some shares, and that some brokers were themselves engaged in this activity on their own account or through associated companies. The dangers of this practice to the stability of the market became clear in the case of Antimony Nickel in early 1971 when a very large volume of Antimony Nickel shares were sold short on the Sydney Exchange. After the shares had been suspended from quotation (for the second time, 26 March 1971), the Sydney Stock Exchange appointed a subcommittee (May 1971) to carry out an inquiry 'to investigate all matters leading up to touching on and concerning the suspension of Antimony Nickel N.L.; and to consider if and in what circumstances the suspension should be lifted.' The subcommittee's report (5 August 1971) was not published but was made available to us. It established that there was a large short position in the shares and stated that 'a lifting of the suspension in the light of existing circumstances could only lead to a distortion of the market, to an extent that it would be neither an informed nor a free or rational market.' The report did not discuss the financial position of the firms which were short. However, our own detailed inquiries established that at least two members of the Sydney Stock Exchange had, on their own accounts, sold the shares short to such an extent that they would have been placed in a serious financial position had they been required to 'cover' their short sales through purchases in the market at the prevailing prices (which were much higher than those at which the brokers had sold the shares). The suspension of quotation of the Antimony Nickel shares by the Sydney Exchange enabled these firms to avoid the financial predicament which had been brought about by their own actions. In this way the firms were protected from incurring a dangerous financial loss which could have caused their default and the stock exchange was protected from the embarrassment which would have followed. (For an example of a series of large transactions similar in nature to short selling which were carried out in a falling market, see Ev. 2714-35. These transactions took place in Poseidon shares and involved a broking firm and its affiliated company. The broker described his position as a 'protected bear'.)

(vi) Rules to deal with corners. Notwithstanding the notorious history of corners in share and commodity markets around the world and the existence of rules to deal with them, the Antimony Nickel case (just mentioned) demonstrated that the Sydney Stock Exchange did not have a rule to deal with corners (Ev. 250). To protect member firms against their clients, the Sydney Stock Exchange ultimately followed the New York Stock Exchange rule.

(vii) Rules to require members of the stock exchanges to yield priority to their clients' orders in preference to their own or those of their associaties (Ev. 530-532). In Chapter 11 (Public Issues), it is pointed out that the Sydney Exchange still has no such rule in spite of the fact that such a rule must be considered an elementary part of the structure of regulation necessary to reinforce the obligations of a broker to his client.

(viii) Rules to see that a broker's recommendation is suited to the requirements of his client. The 'know-your-customer' rules are regarded as important in the United States.

(ix) Rules of the treatment of discretionary accounts. We have noted that in some overseas markets rules have been designed to control 'churning' of clients' funds. For an example of the treatment of a large discretionary account in Australia, see Chapter 7, Investment Consultants, Sharebrokers and Share Tipping.

(x) Regulation of 'line-switching' or 'hotch-potch'.

(xi) Regulation of intra-office responsibility for observance of proper procedures and the rules themselves.

(xii) Regulation of the qualifications of members of stock exchanges and investment advisers.

(xiii) Regulation of the use of brokers' newsletters and the quality of the analysis and advice therein (Ev. 1678-79 & 1690-91). We found clear evidence of brokers recommending in their newsletters the shares of companies with which they were associated in various ways (as directors, underwriters, investors and share traders) without disclosing their interests in the shares. In some instances it appeared that inside information had been used in preparing the newsletters (see Chapter 2, Poseidon; Chapter 4, Martin). While many brokers have achieved a high standard of analysis in their publications, some firms have circulated market letters, bulletins and reports in which unduly optimistic recommendations have been based on slipshod analysis.

(xiv) Regulation of the relationships between members of stock exchanges and investment consultants who publish 'tipping sheets'. We have been concerned about investment consultants 'tipping' share issues being underwritten or sold by brokers with whom consultants have been associated at the time (see, for example, Chapter 7, Investment Consultants, Sharebrokers and Share Tipping; also Chapter 9).

The Committee gave particular attention to stock exchange rules and procedures concerned with ensuring the financial soundness of member firms. The evidence of Mr E.H. Niemann, a chartered accountant with experience of auditing member firms of the Melbourne Exchange, was particularly relevant in this context. It highlighted the defective procedures followed by the Melbourne Exchange for early detection of an unfavourable trend in a broker's financial position. Mr Niemann explained, for example, that during the course of a year an auditor could become aware that a firm was in serious trouble or even insolvent, but he had no responsibility or right to report that information until the end of the financial year. The evidence also revealed that auditors charged with the function of assessing the financial situation of member firms did not have any guidelines from the stock exchange as to what constituted an adequate financial position. As the stock exchange did not itself receive the firms' balance sheets and profit and loss accounts, it was dependent upon the judgments of various auditors as to whether the member firms were operating from sound financial positions (see Ev. 940-58). (Since Mr Niemann gave this evidence the Melbourne Exchange has taken some steps to tighten up its auditing procedures.)

At the request of the Committee, Mr Niemann also prepared a submission on aspects of the accountancy and audit of stockbroking firms. His report (Committee Document 15-1) shows how the accounting problems faced by stock brokers are unusual and complex, particularly in respect to the interlocking of the accounting records and scrip records. It also describes the uses and abuses of 'line-switching', and refers to the possibility of abuses arising from employees' trading. (For a discussion of some defects in the Sydney Stock Exchange audits see Ev. 1045-47; also 940-58).

We have also observed that some of the rules of the exchanges are more explicable as elements of restrictive trade practices than as regulatory functions carried out in the public interest. The rules establishing fixed commission rates are perhaps the most obvious example. Little consideration appears to have been given to the question of competition in setting commission rates. This, in particular, is a matter on which it is unrealistic to expect disinterested action by the stock exchanges. Aspects of the 'Anglo-Australian Agreement' which are concerned with the terms upon which non-member underwriters may deal with stock exchange members may also come within the category of restrictive trade practices (Ev. 1512-14).

Despite the formulation of the so-called 'Uniform Rules' of the A.A.S.E., we have found significant differences between the rules of the various exchanges regulating important aspects of their members' behaviour (Ev. 1638-39). Given the national character of the market, to which reference is made later, these variations appear to be undesirable anomalies. Mr Niemann's report refers to one aspect of this problem, namely the difficulties faced by auditors in reconciling the accounts of a member of one exchange with the accounts of brokers belonging to other exchanges.

Even where the exchanges have formulated rules on matters of regulatory significance, we have found a conspicuous failure to ensure the detection of breaches and to enforce the rules. There has been an excessive and optimistic reliance on the 'grapevine' to bring breaches to light. The Committee was repeatedly informed, either in evidence or in the course of other discussion, that if a broker were engaged in malpractices these dealings would be discovered by other members and reported to the exchange (Ev. 398 & 551). In the light of our observation of numerous detailed instances of objectionable practices which would not have been revealed but for this inquiry conducted under the investigatory powers of the Senate, we have no confidence in that assumption. Chapters 2 (Poseidon), 4 (Martin), 5 (Ricketson), 6 (A Broker-underwriter), 8 (Runs, Pools and Rumours), 10 (Private Issues) and 11 (Public Issues) contain many examples of breaches of important rules and commonly accepted standards of fair play. We found, for instance, that some stock exchange members repeatedly acted as principals in transactions with their clients but continued to charge commission as though they had been acting as agents and, further, failed to disclose their interest in the transactions to their clients. One stock exchange member claimed that it was in accordance with the stock exchange rules for him to continue to charge commission while dealing with clients as a principal (Chapter 2, Poseidon, Mr Shierlaw's evidence). We have also been concerned at the improper use by some brokers of their clients' scrip. These and other instances which came to our attention make it apparent that it is not enough to provide a rule and expect that members of stock exchanges will customarily observe it in the absence of sanctions and an effective system for detection of breaches. The extensive and repeated evidence of breaches of exchange rules requiring the segregation of clients' funds in trust accounts provides startling support for this conclusion. (For an analysis of the extensive qualifications in the audit reports of Sydney brokers in 1970, see Ev. 1060-72.)

Moreover, we found little inclination on the part of some brokers to guide their behaviour by reference to the spirit of the regulations. Rather, we encountered some instances where legal and accounting advice had been sought from prominent firms to devise ways of circumventing the letter of existing rules.

The evidence we have received and the case studies we have reported have also led us to conclude that the exchanges are unlikely to achieve adequate regulation except under the stimulus of a government authority. We have found that, within the stock exchanges, there are full-time professional executives charged with the responsibility of seeing that listed companies conform with the stock exchange list requirements (Ev. 1483). However, these executives have no power on their own initiative to investigate the internal records of a member firm or, in the case of one exchange, the broker-to-client computer records which are kept within that exchange. The policing of stock exchange rules which govern members' activities is not carried out by professional executive staff as it is, for example, in the New York Exchange. The executive staff in Australia has been delegated minimal investigatory responsibilities in this respect (see especially Chapter 2, Poseidon, Mr Hynam's evidence; also Ev. 1043, 1051 & 1057). One senior executive of an exchange informed us that 'in the ordinary day-to-day activities of the exchange, there is no investigation.' He added that 'there is no real enforcement of the rules unless somebody steps right out of line and it becomes obvious.' Based on his own experience, he believed 'a great leap forward' was needed in the regulation of the exchanges.

Although some stock exchange executives have, from time to time, been able to bring matters concerning members before the stock exchange committees, in practice the fetters on their independence of action has resulted in their displaying far less initiative and aggressiveness in regulation of members of their exchanges than in the regulation of listed companies. The stock exchange committees have retained to themselves the power and responsibility for regulating their own and fellow members' affairs (Ev. 1485). In most cases, this has meant that effective regulation has depended greatly upon the available time, understanding and personal inclinations of the chairman, who has also had his own stock exchange business to run(Ev. 549-551). Based upon our inquiries, we have concluded that the committee and chairmen have gone about this regulation in an unprofessional, piecemeal and haphazard manner (see Chapters 2, Poseidon; 4, Martin; 5, Ricketson; 6 A Broker-Underwriter; 8, Runs, Pools and Rumours;

10, Private Issues; 11, Public Issues). What is disturbing is not only the ad hoc, casual and clubbish approach, but the fact that in some cases members of the stock exchange committees were themselves deeply involved in the improper and manipulatory practices so obviously in need of regulation. Our observation that other committee members were noticeably reticent about discussing abuses and malpractices which must have come to their attention has also caused us concern.

It is, in our view, highly significant that, despite the public discussion of stock exchange affairs over several years and the stock exchanges' stated intentions of tightening their procedures, there is still no one full-time person within any stock exchange concerned with the regulation of the activities of members and delegated power necessary to investigate fully the records of member firms. Substantial funds have been spent by the stock exchanges in financing the development of the Australian Associated Stock Exchanges, and there has been much publicity associated with the build-up of the staff of this body, but the A.A.S.E. and its President have no control over stock exchange members (Ev. 1637). The staff of the A.A.S.E. do not perform any investigatory function.

Your Committee's general conclusion is that the performance of the committees of the exchanges in the matter of providing rules on many aspects of their members' behaviour has fallen far short of the desirable standard. The inquiry has demonstrated that one cannot rely solely on the hope that all brokers in Australia will observe unstated ethical obligations and demonstrate a sufficient understanding of their obligations to make rules unnecessary.

15.17

Regulation of the Market

The performance by the stock exchanges of the second function mentioned above - that of regulating the market itself -has also been defective. We have already referred to the limits on the capacity and power of the stock exchanges to make this area of regulation more effective.

It is true that the stock exchanges have generally been ahead of company law in the requirements they lay down with respect to the accounts, articles and various activities of listed public companies. They have succeeded in reaching a common set of listing requirements, though there has still been some variation in practice between the exchanges. The executives of the exchanges, with the aid of greater delegation of authority from the committees than they have with respect to regulation of members, have also performed valuable service in various ways in regulating the market.

But in our view stock exchanges have been too willing to grant listing to companies with no substantial record or with arrangements which have favoured the promoters far too blatantly. They have, moreover, been too slow in tightening listing requirements. It has also disturbed us that, with respect to many listing applications, members, including committee members, have been substantially interested in the companies concerned, as promoters, consultants, shareholders, underwriters and directors.

Enforcement of the A.A.S.E. list requirements has also been defective in various respects. There have been instances where directors of listed companies have ignored the rules because they have been rules of a stock exchange, unsupported by legislation (see, for example, Chapter 12, Garretty). In addition, the difficulty of the exchanges in ensuring compliance with their requirements as to accounts is well-known and requires some legislative attention. The evidence has also demonstrated some laxity in insisting on observance of these requirements. However, the aspect of performance in this area of which we are most critical concerns the necessity that investors be protected by maintenance of an informed and fair market. There have been too many instances when the market price of a share has risen or fallen substantially without there being any satisfactory explanation to the stock exchanges at the time of the market movement. Our observation of some overseas markets suggests that there is no good reason why the exchanges should not have been far more aggressive in their protection of the markets. Systems for alerting officials to significant movements, 'trading halts', the more ready use of suspensions, requirements as to the method of making announcements and closer scrutiny of them, have all been used with benefit to markets overseas. In some cases (e.g. the Tasminex case investigated by Mr Wilson, an inspector appointed under the Companies Act), the use of such procedures in Australia would have prevented some of the outrageous profits realised by insiders during the most recent mineral share boom.

So far as surveillance of the trading market is concerned, our examination of action taken to detect and follow up fraud, insider trading, manipulation and other improper practice prompts several comments. One is that though the executives of some of the exchanges have endeavoured to detect instances of possible abuse, the task has been performed in an erratic, ad hoc way. In the result, far too many serious instances have passed without action. We have also received clear evidence that some members of the stock exchanges have been involved in organising 'runs' in the market and in manipulating share prices in other ways (see Chapters 4, Martin; 8, Runs, Pools and Rumours; 10, Private Issues; 11, Public Issues). Further, as already stated, the exchanges do not have power to follow, beyond the records of their members, any inquiries they do begin; hence in these circumstances the value of such surveillance as is carried out by the exchanges depends upon the effectiveness of the follow up by the Companies Offices.

In sum, we consider that the exchanges have neither the jurisdiction, the power, the disinterested will and lack of bias nor the appropriate full-time professional approach to warrant the assumption that they are the principal and best regulators of the securities market and their members. We have no doubt that there will need to be a substantial self-regulatory role for stock exchanges. However, in our opinion a body with broader authority and greater sympathy with the public interest is required in order to stimulate the stock exchanges to carry out their self-regulatory functions.

Failings of the State Companies Offices

Government regulation of public companies, the securities market and the securities industry has, until recently, developed almost entirely within the context of the Compatibles Acts and Ordinances of the States and Territories. These have been administered by the Registrars of Companies through the Companies Offices.

Beginning in 1970, four States have also enacted securities industry legislation. The New South Wales Registrar has also become the Commissioner for Corporate Affairs and the Queensland Registrar has been given the title of Commissioner. The securities industry legislation is concerned with registration of stock markets and intermediaries and with some aspects of trading in securities. The regulation of companies, including offers to the public of their securities, their accounts, takeovers and the regulation of investment companies and debenture trust deeds continues to be principally a matter for the Companies Acts. Both sets of legislation continue to be administered for the most part by the Companies Offices. There has been some expansion or up-grading of staff in some States to deal with the new securities industry legislation and with recent amendments to some of the Companies Acts.

Despite these developments, however, it is our view that the State regulatory authorities and State Acts have not adequately and effectively met the need for regulation of the securities market and of public company activities impinging on it. A principal cause of this situation is that the Companies Offices are not nationally effective.

One of the main themes of this Report, discussed at some length in the next chapter, is that the securities market is largely an interacting national market. Yet not one of the Companies Offices and none of the State and Territorial Acts has a national operation. In several chapters we have described in detail how the proper understanding and detection of manipulatory and improper practices often depends upon an investigator watching closely and concurrently the activities in several cities and then moving swiftly to collect and examine documents in these cities. An investigator confined to one capital city can frequently see only a limited part of the picture. There is a need for a body which watches closely the entire Australian securities market and which will investigate expeditiously on a national scale.

A highly qualified witness who had had experience in Companies Office administration shares this view. He submitted that he 'would favour the national body certainly in relation to the securities industry legislation as it is presently emerging'. His reason was as follows: 'I favour it because of the fact that there is in truth only one market throughout Australia although the business is transacted in various centres. You need to be able to get information and to interrogate brokers in all States in relation to a particular transaction. There are some difficulties in the way of doing that on a State basis.'

When asked if he thought a national body 'would achieve greater speed' in its investigations, he replied: 'I think that is indubitably the case, if you have one body which perhaps also would have representatives in each of the States'.

The same witness was also asked if he thought the national body should be charged with the function of examining and accepting for registration on a national basis all prospectuses. He replied: 'Given the differences which presently exist in the legislation of the States and the differing strength at the administrative level, I think I would have to agree with that proposition too'.

A second reason for our conclusion about the inadequacy of State regulation is that there is a substantial lack of national uniformity in:

(i) the relevant law;

(ii) the administrative practice in respect to the law;

(iii) the quality of its administration.

The Relevant Law

The so-called uniform Companies Acts have never been entirely uniform for all States and Territories. In recent years there have been serious departures from uniformity in, for example, their provisions on accounts, audit and duties of directors.

Further, only four States have adopted the securities industry legislation, and there are important differences between those four Acts, for example, on licensing of brokers, short-selling and insider trading. Recent experience with attempts to secure uniformity in the important areas covered by the Eggleston Committee reports and in securities industry legislation suggests that it will be impossible to guarantee uniformity while it is necessary to obtain the agreement of seven governments and enactment by seven parliaments.

Company and securities laws have always been subject to frequent change to cope with new developments and standards. Indeed, it is necessary for arrangements to be made so that governmental and administrative reaction to developments can be quite rapid. Hence the need for rule-making and like powers. But the present system, requiring the initial agreement of seven parliaments, is inherently ill-suited to ensure uniform and, at the same time, rapid adjustment. Proposed changes may have to be abandoned, or they may be proceeded with in some States and not in others, or agreement and uniform action may come only slowly. In recent years some States have unilaterally gone ahead with changes resulting in serious departures from uniformity, as was the case, for example, with the action of New South Wales in relation to insider trading. In Victoria the failure to require licensing of brokers, and in several States the variations in recent amendments to the provisions on accounts, audit and directors reports, have not been explicable by any major considerations of policy or local needs or circumstances.

Where there is lack of uniformity the consequences may be arbitrary variation in the treatment of similar behaviour. Because of the need to avoid outerlapping State laws and jurisdiction, the place of incorporation often determines which State law and administration applies. Yet, for a company operating in several States, the choice of State of incorporation may be an accident. The determination of the applicable law then becomes governed by arbitrary factors. But two companies operating nationally should not have different standards of disclosure and behaviour applicable to them. Transactions in securities on the national markets should not be governed by different standards depending on some accidents of territorial nexus. It is for this reason that we are critical of a situation in which New South Wales has one law on insider trading and Western Australia and Victoria another. We feel the same way about Western Australia having one law on short-selling and New South Wales another.

Moreover, lack of uniformity in the company and securities laws causes complexity, imposes extra costs on business and produces haphazard regulations or arbitrary enforcement.

The witness quoted earlier also said that his experience of the difficulty involved in gaining acceptance by State Parliaments of proposed laws which have been recommended at the level of the Standing Committee of Attorneys-General confirmed his view that a Commonwealth Act would not be repugnant to him.

<u>Lack of Uniformity in Administrative Practices</u>

Uniformity in legislation has not led to uniformity of interpretation of laws by administrators. In relation to prospectuses, accounts and many other matters, there is considerable room for variation in what commissioners, registrars or their officers will regard as necessary. With this in mind, some effort has been made to secure uniform administrative action. But the task appears to be so onerous and time-consuming as to give some cause for questioning the wisdom of maintaining all the separate administrations which necessitate it. The Committee raised this matter with the New South Wales Commissioner for Corporate Affairs, Mr F.J.O. Ryan.

Senator Rae: Do you see this co-operative administrative method as being a method which is developing and working successfully?

Mr Ryan: Yes.

Senator Rae: Over what period of time would you say it has come into its own?

Mr Ryan: I think it is a system that has developed directly from the meetings of officers which preceded the drafting of the uniform Companies Bill and which has continued. All registrars without exception recognise the desirability of a uniform approach over the whole of Australia and continually strive to achieve that.

Senator Rae: It is rather expensive of time, is it not? On the figures you quote 7 to 10 days, 4 times a year, is about one in every 8 working days which would have to be spent by the registrars and presumably some other officers in meeting to discuss and develop.

Mr Ryan: That is true.

Senator Rae: Discuss and develop?

Mr Ryan: Yes, but of course meetings are not held for that purpose only. It is a prelude to the Standing Committee meeting to advise the Ministers on policy and so on. No doubt it would be a much simpler and straightforward process if one Registrar were able to tell the others what he wanted them to do. There is no question about that.

Senator Rae: I was just wondering whether you thought something like one day in 8 working days was constituting a substantial drain on the time available to get on with the other areas of activity necessary from the Companies Registrars?

Mr Ryan: It is a substantial drain. It does make significant demands on Registrars. This is part of the Registrar's job in this stage of the development.

Senator Rae: However onerous it may be in that way, you see it as being a highly desirable way of achieving growth and uniformity?

Mr Ryan: Yes, an essential adjunct to the present uniform legislation at State level.

(Ev. 1026)

Moreover, in our observation there are numerous variations of importance in what particular commissioners or registrars require, whether because of differing interpretations of legislation, differences in what they happen to think appropriate in particular instances, differences in accompanying formalities dictated as they see it by local law (for example, as to the form in which statutory declarations are to be made) or in requirements purely as to form and appearance (for example, as to whether backsheets are required or not). These variations can create difficulties for people trying to operate nationally.

Lack of Uniformity in Quality of Administration

An associated aspect is that uniformity in law and attempts to overcome variation in administrative practice do not necessarily involve a uniform quality in administration. A prospectus issued by a company which happens to be incorporated in State 'A' may receive more rigorous scrutiny than one issued by a company incorporated in State 'B', though they may carry on business in the same States, attract investors from the same areas and be listed on the same stock exchanges. Proposals for improvement in law and administration may proceed from far greater understanding in one State than in another. Investigation in one State and prosecution there may be more effective and efficient than in another. In other words, the quality of the various administrations varied greatly. This is not surprising in view of the small size of some of them and the relative scarcity of expertise. Some State administrations are seriously undermanned despite the substantial revenues which flow from the operations of the Offices. One effect may be to attract the less scrupulous company promoters to 'weak' States. It may also mean that effective investigatory or enforcement action depends on which State is regarded in practice as having jurisdiction over a company or activity. The Committee received evidence of instances where the administration in a State in which many transactions occurred in a stock kept a file on the events but left it to another State's Companies Office to take action because the company happened to be incorporated there, whilst its main operations were in yet a third State. The State of incorporation in fact took no action.

It is only recently that any of the Companies Offices appear to have developed significant concern with the stock markets, brokers and others in the securities industry. Historically~ their principal functions have been to receive and process incorporating documents and returns and to handle a substantial volume of inquiries. They have performed these functions for all types of companies including proprietary companies, both exempt and non-exempt, which far outnumber listed public companies. They have also traditionally administered the Business Names legislation. Some Registrars have administered other Acts, the Queensland Registrar in particular having onerous responsibilities under several commercial acts.

The volume of work associated with the performance of these routine functions has always been great, and its significance for State revenues is considerable. Most of the staff of Companies Offices have been employed to perform these functions, and allocation of staff to discharge them has always been high on the list of priorities. The basic training of persons performing these tasks has generally been minimal, and the salary scales low. On the other hand, with long experience, the Offices have developed some efficiency in handling the paperwork and some, notably New South Wales~ have instituted modern machinery and systems for doing so.

Our inquiry has, however, been concerned with the quality of performance of functions bearing on the adequacy of initial and continuing disclosure to the market for public company securities, of regulation of the relations of managers of investment companies to those companies, of regulation of the securities market and securities industry, and of surveillance, investigation and prosecution action with respect to abuses in these areas.

We find three crucial areas in which the Offices are not able to produce adequate quality and effectiveness of administration.

(i) Investigation and enforcement action

The volume of matters for investigatory action arising as a result of complaints, liquidator's reports and in order to enforce the business names legislation is great. Even in those States which have Companies Offices of substantial size, the investigatory staff has not been available to ensure that the major work of investigating possible abuses in connection with public companies and the securities market has been carried out comprehensively and expeditiously. Evidence and information received by this Committee disclosed an alarming number of public company and stock market situations which should have been, but were either not, or not promptly, investigated. The difficulties of recruiting staff with the expertise and understanding of the market and public companies necessary to detect and investigate effectively and to develop adequate surveillance of the securities market have been, still are, and will probably continue to be, great. Given eight bodies (counting the Northern Territory separately) there is little prospect that the Companies Offices, particularly in the small States, will ever acquire investigatory talent of the required calibre.

In some States in which the smaller exchanges are located there is still heavy reliance on Fraud Squad divisions of the police force. These divisions may deal effectively with fraud in some companies, but they do not have sufficient experience, expertise or manpower to tackle public company or securities market abuses over which the small States may, by accident of incorporation or other circumstances, have jurisdiction but which commonly have nation-wide and international ramifications and involve resourceful wrong-doers.

Even when the work of investigation is carried out there seems little prospect of speedy and effective prosecution. Where there is a possibility of prosecution as the result of investigation by an investigator, appointed under the Companies Act, by a Companies Office investigator, or by a fraud squad, cases are, for the most part, referred to the appropriate Crown Solicitor's Office. The delay in handling these cases by those offices is notorious and has recently been the subject of criticism in New South Wales. In our view, these Offices also do not have the expertise or manpower to handle cases in the area with which we are concerned.

(ii) Administrative functions

In an economy with a developed securities market, a regulatory body must perform a wide range of administrative functions. These include functions in relation to disclosure documents among which is the scrutiny of prospectuses to ensure that they contain information which is full and accurate enough to enable an investor to make a sound judgment about a venture. In the Companies Offices in some States, the examination of prospectuses has been carried out in a perfunctory way, involving little more than checking the prospectus and accompanying documents to ensure that they contain statements which appear to meet the requirements of the Companies Acts - in particular, those in the Fifth Schedule. Though significant efforts have been made to upgrade the quality of scrutiny of prospectuses in some of the

Offices, we received evidence in relation to some States that the numbers and expertise of the staff available to perform this function has generally been very limited and its turnover in some Offices rapid. There has been a tendency to an excessive concern with fine points of wording rather than with the broader question whether a full and accurate picture emerges of the business realities of the venture and whether its risks are sufficiently exposed.

The examination of prospectuses is only one of many functions which should be performed. Another is the exercising of the power to grant exemptions from compliance with requirements on accounts. Other administrative functions involve powers to act in takeover situations, to require suspension of trading in securities, to intervene to protect shareholders in public companies and to exercise rule-making powers in certain situations. But the expertise and general competence necessary to the adequate performance of such functions is beyond what can reasonably be expected of each of the separate State and Territorial Companies Offices.

(iii) Legislation, regulations and administrative system

Expeditious improvement in the legislation, regulations and administrative system which regulates the securities market and public company activities impinging on them, requires a good understanding of the securities market and a constant awareness of new practices. It is one of the great virtues of the United States Securities and Exchange Commission that it has developed a core of expertise and understanding which can discharge this function successfully and in so doing fill a leadership role in the improvement of the securities market. We find that not one Companies Office has a repository of the necessary expertise.

We found in the securities markets a high level of abuse and much behaviour falling short of minimum acceptable standards of fair dealing, competence and responsibility. After examination of the existing body of law, rules and administrative practices, we have concluded that these fail to provide adequate and effective regulation. In our view there is a need for a new approach to securities regulation in Australia. We consider the alternatives in the next chapter.

CHAPTER 16

THE NEED FOR AN AUSTRALIAN SECURITIES COMMISSION

National Character of the Market and its Implications

When considering the regulatory needs of the securities market, it is essential to reeognise the national character of the activities being regulated.

The evidence has repeatedly established that the securities market is a national market. Each of the stock exchanges functions as part of a national network. A large proportion of the business of the smaller exchanges is transacted in Melbourne and Sydney, and a substantial proportion of the total business in Australia is effected across State boundaries. For most listed securities there is, in practice, one market in which prices are set by national forces of supply and demand. Stock exchange member firms and other intermediaries place new securities and orders throughout the country. In many cases they have offices in more than one State or in the Territories. The exchanges have increasingly moved to rationalise their organisation accordingly. They have a set of common listing requirements. There are some uniform rules. There has been consideration of developing further links between the exchanges to co-ordinate their trading arrangements.

To a great extent, listed public companies, investment companies and others with which we have been concerned carry on business nationally. They use professional assistance from around the country. They raise capital nationally in the securities market, and (to facilitate the creation of a national trading market for their securities) are frequently listed on the stock exchanges in several States.

Although we have been largely concerned with the market in listed shares, we have given some attention to the workings of the other securities markets: those dealing in large short-term money deposits, commercial bills, inter-company loans and government securities. We have seen how the operations of these markets have, to varying extents, become integrated with the ordinary share market. Chapter 14, Minsec, illustrates this point particularly well. It is clear that, on most working days, huge volumes of funds move around Australia within these markets. Collectively, they make up a national capital market.

A major purpose of federation was to create a national economy. The growth of a strong securities market in which funds can be raised nationally to finance capital formation must be regarded as a logical, and presumably, expected result of that objective.

It would, therefore, appear that the regulatory system should facilitate and encourage the development of a national securities market. Separate or duplicated laws of the States and Territories regulating the securities market are obviously required when there is no national legislation. Nevertheless, one of the effects of having separate laws rather than national legislation has been to obstruct and burden unnecessarily the development of the national market. For example, a company should be able to raise capital nationally without having to register a prospectus in every State and Territory. It should be required to keep the public market informed, but not by the filing of accounts in every State and Territory in which it carries on business. It should be able to operate through subsidiaries incorporated in different States and Territories without having to cope with diverse accounting requirements. An intermediary or adviser in the securities industry should be able to conduct business in more than one State without having to obtain a licence or lodge substantial security in each State of operation.

One of the inevitable results of having a national market is that an investigation of any substantial abuse in the market will often have to be carried out nationally. That, certainly, was our experience. At the moment the New South Wales and Victorian Companies Offices are increasingly endeavouring to act as national regulatory and investigatory authorities. There are great difficulties in the way of this, some of which we pointed out in the preceding chapters. It is not appropriate that the administrative body of one State should seek to act as a national body. We have seen how it sometimes happens that jurisdiction is thought to lie with a State which is not equipped to handle an investigation within its own province: it follows that this State is even less capable of coping with a national investigation. We are strongly of the view that many of the abuses in the securities markets can only be effectively investigated by a national regulatory authority.

It also makes for confusion and arbitrary legal consequences, and aids ingenious persons who may wish to engage in undesirable behaviour, if there is a different law in each State with respect to insider trading, short-selling, disclosure of dealings as a principal and the many other activities which need regulation. We have also observed that problems arise from the variations in stock exchange regulations on some matters. Concern was expressed, for example, over the lack of uniformity in regulations on brokers' accounts and audit procedures. We believe these difficulties will be overcome only if there is one nationally uniform body of law and a national authority which will ensure the self-regulatory requirements on some matters are standardized.

A national regulatory body could also eliminate the variation in administrative practice and standardise the quality of administrative action. We referred to these problems in the previous chapter. A particular advantage which could flow from establishing one body is the opportunity to develop nationally more flexibility and certainty in the administration of securities regulation. For example, the Eggleston Committee in its interim report on Accounts and Audit (paras 41-48) considered that there should be power to grant relief in appropriate circumstances from compliance with the statutory requirements relating to accounts and power also to add to or vary those requirements. It said (in para 42-43) that there are:

> ... inherent difficulties in formulating statutory requirements which will at all times and in all circumstances be properly and fairly applicable to all companies and groups of companies regardless of their size, the nature of their operations or the number and character of their shareholders ... no matter how far it pursued its enquiries the <u>Committee could never be assured that the statutory requirements would not in some circumstances operate harshly or prove impossible of performance ...</u>

The Committee also said:

> ... if there is to be any provision in this regard the power to exempt should be exercised by a single body which will apply uniform standards for all companies wheresoever incorporated in Australia ...
>
> (Para. 46)

Clearly, given the national character of the activities of many companies, nationally uniform standards should apply wherever the place of incorporation.

The Eggleston Committee went on to recommend that a Companies Commission be set up by joint governmental action. The recommendation, which was not adopted, was made before the decision of the High Court in the <u>Concrete Pipes Case</u>. What the Companies Acts have in fact done is provide that the relevant Commissioner or Registrar may give relief as to the form and contents of the accounts and accompanying directors' reports and that in so doing he 'shall take into account' any views that he knows to be held by the persons exercising similar functions in the other States or Territories. We believe that this is not a satisfactory substitute for administrative action by a single body of the type envisaged by the Eggleston Committee. Experience has shown that many commissioners or registrars will adhere to their own views and that uniformity will be difficult to achieve.

Moreover, administrative discretions and powers are needed to deal with matters other than company accounts. For example, an effective regulatory authority needs scope for flexibility in relation to the disclosure made in prospectuses and takeover documents. It should possess powers of intervention in takeovers. It should develop the practice of stating an administrative interpretation or position in relation to a particular matter such as is exercised through the 'no action' letters of the United States Securities and Exchange Commission. This practice assists the cause of certainty in commercial arrangements.

Another aspect of the securities markets requiring special mention is that various intermediaries are forming associations and tending to speak collectively through these associations. In some cases they have great power and influence. However, with regulatory authority and expertise divided among seven governments (eight administrative bodies, counting the Northern Territory Office separately), it is generally not clear who has responsibility to be aware of market developments and to respond to them. There is a lack of vigilant, effective leadership by the regulators. One consequence has been insufficient pressure on self-regulatory bodies to put their houses in order. A related problem has been the existence of market practices requiring regulation for which no one appears to have been accepting responsibility. Underwriting is an example (see Chapter 11, Public Issues, also Ev. 554). Abuses involving overseas operations of Australian brokers is another (see Chapter 10, Private Issues).

The creation of one national regulatory body with comprehensive responsibility could meet these needs.

It must also be stressed that many of the buyers and sellers in the securities market, and many of the intermediaries involved, operate from overseas. A large volume of dealing in securities of Australian companies has taken place in overseas markets. Some Australian brokers maintain overseas offices. Several firms have joined with overseas brokers in dealing in Australian shares in foreign markets. We have seen how these overseas operations of Australian brokers have been used to manipulate the Australian market (see Chapter 10, Private Issues). We found serious trading abuses which involved the use of foreign accounts and foreign companies and trusts. Reports on recent experience with investigations of securities industry matters by State Companies Offices reveal that sometimes such inquiries are abandoned because the investigators come up against a foreign company or foreign transaction. Australian and overseas experience in investigating and regulating securities markets indicates the necessity for involving the government which is responsible for conduct of the nation's affairs internationally. Co-operative arrangements and treaties will need to be made with foreign governments and commissions if regulation is to be effective. There has been a substantial development of such co-operation between North American and European regulators in recent years and similar co-operation is needed between Australia and other countries. From time to time extradition and other proceedings may need to be taken overseas. Exchange control and other matters affecting Australia's external relations may also be involved. Such international ramifications must be dealt with by the Crown in the right of the Commonwealth if securities regulation is to be adequate and effective.

In brief, we consider that nationally uniform regulation and a national regulatory body are necessary. Before proceeding to discuss how, in our view, these changes should be brought about, we want to refer to two suggestions which have been made to us.

Proposals for Self-Regulatory Bodies: a 'City Panel'

An issue repeatedly raised in the course of our hearings has been whether national regulation of the securities market should be left essentially to non-governmental or 'self-regulatory' bodies.

The City Panel on Takeovers and Mergers in the United Kingdom has often been cited as an example of a relatively successful non-governmental regulatory body which Australia could follow.

That Panel has been concerned with the application of the general standards and rules of the 'City Code' to takeovers and mergers. It has also involved itself in related activities such as insider dealing. Its members can meet at short notice. If necessary, decisions can be made by telephone. It also, presumably, draws on the considerable expertise of its members. Similar advantages have been claimed, we note, for the committees of the stock exchanges, but we have not found them to be a panacea in the Australian regulatory context.

It is not an easy matter to judge how successful the City Panel has been. The criticism has been made that its rules are too vague and that its decisions may depend on its members' personal views of business morality. (Business Editorial, London Times, Feb. 17, 1972; L. Sploliansky and B.N. Buckley, 'Practice and Procedures for Takeovers in England', Nov. 1972, The

Business Lawyer). Compliance with its views and its requests for information is largely voluntary. Furthermore, the reports of the Panel do not reveal many of the details of its activities. In such circumstances one cannot be sure if it has obtained the full story when it has carried out investigations.

In any event, whatever its suitability for the London market, we do not believe that a body modelled on the City Panel provides the answer to the need in Australia for an effective regulatory body.

It may be fruitful to state the grounds on which this belief is based.

(i) It needs to be realised that the City Panel has been primarily concerned with a limited function - scrutiny of takeovers and mergers. With the aid of full-time staff, this Panel of busy people, has been able to perform this limited function. It is not the type of body which is needed for adequate regulation of the large range of matters involved in the securities market and the securities industry. If offers, in that respect, no improvement on the committees of the stock exchanges.

(ii) The Panel has no investigatory powers in law nor can it apply government sanctions. It relies heavily on the influence it can bring to bear on merchant bankers and others in the securities industry who accept a common code of commercial morality. We do not believe that such a body would be successful in dealing with some of Australia's most serious regulatory shortcomings.

It is notable that the Panel's endearours to deal with insider trading led it to comment in its report for the year ended 31 March 1973 that it is hampered in its surveillance of market transactions in connection with takeovers 'not only by the use of nominee names but also by the absence of a statutory power to interrogate or demand production of documents'. Clearly, regulation of a securities market involves inquiry into fraud or abuse which will not be voluntarily confessed and with respect to which governmental investigatory power is needed. We do not believe that such investigatory power or the power to apply sanctions should be conferred on a 'self-regulatory' body. We consider that such powers should be entrusted to the administrative, executive and judicial arms of government. Further, much of the abuse of investors in Australia has been by controllers of companies and others outside the securities industry as such. A body like the City Panel is not equipped to deal with people who are not merchant bankers, brokers or others in the securities industry. Its sanctions are difficult to apply to such outsiders. Sanctions laid down in legislation and applied through judicial and executive processes are necessary to protect the public. There is an element of wishful thinking in advocacy by merchant bankers with London experience of the Takeover Panel for the establishment of such a Panel in Australia so as to remove the need for a government regulatory body.

(iii) The Panel has the advantage of regulating a securities industry which is for the most part located within the City of London. Its jurisdiction is essentially over a close-knit group within that area. The Australian market is far more dispersed.

(iv) The Panel is essentially an 'in club' body. Such organisations may serve the interests of those regulated by maintaining secrecy. The public interest should in our view be protected by a government body which is not dominated by sectional interests.

It should also be mentioned that the Bank of England has played a role in the establishment and operation of the City Panel.

Senator Rae: The Bank of England is involved in the work of the Panel?

Mr Castleman: In a fairly mixed way. The Panel operates under the auspices of the Bank of England. There has usually been a senior member of the Bank of England on the staff of the Panel. One of their more junior but outstanding guys has been on the permanent secretariat of the Panel. I would not see the Bank playing a prime function in the modus operandi. I give that much more to the Stock Exchange and the merchant banks and other institutions.

Senator Rae: But so far as policy is concerned, and so far as some outsider to see that there is fair play is concerned, the Bank of England is sufficiently involved to be able to act in that type of role?

Mr Castleman: Yes, entirely. The Bank of England is a sort of unofficial uncle of London affairs. It is accepted as such.

(Ev. 845)

Our inquiries of the Governor of the Reserve Bank revealed that the Reserve Bank has not played a similar role here:

Senator Rae: Is it correct that in the United Kingdom the Bank of England does act in an informal way to influence the organisation and morality of the markets?

Mr Phillips: I do not know how far that goes. One has the impression that it is probably a rather more pervasive influence there than it is here. Certainly the Bank of England has quite close relations with the Issuing Houses Association, but that is particularly, I think, because they are people who, by putting their names on commercial bills, can make them eligible securities for the Bank to deal with. As I say, one gets the impression that perhaps word from the Bank of England goes around rather more in the City of London than would be the corresponding situation here, but I really to not know in detail how much that is true.

Senator Rae: Why do you think that the Bank of England does extend its sphere of influence in that way, and why is it not regarded as desirable to endeavour, so far as the Reserve Bank is concerned, to extend its sphere of influence?

Mr Phillips: I should think it is partly a matter of history. The history of the Bank of England is a very different one, of course, from ours. It was more involved maybe, in the setting up of some of the market machinery in England in the past than we were. Again, I am not sure how true this is to-day, how much its influence really does extend in those fields, but I should think that insofar as it does it is probably partly historical accident and the differences in the way institutions have grown up and developed.

Senator Rae: Why do you not regard it as either desirable or important that the Reserve Bank of Australia should endeavour to influence what happens, even though it may not have direct power to control or regulate?

Mr Phillips: I think there we would feel, as we said earlier, that if Parliament had wanted us to extend into that field it probably would have told us to.

Senator Rae: Again, until such time as it does, then you do not regard it as a part of your proper role?

Mr Phillips: No.

(Ev. 2922)

The Committee does not consider it appropriate that the Reserve Bank extend its functions so as to become directly involved in regulation of such matters as takeovers. In addition, we do not consider that the nation's central bank should serve the function of legitimising a private self-regulatory body.

The often-cited advantages of the City Panel are its speed of operation and flexibility. It is important that a regulatory body be able to operate quickly and with flexibility in response to events taking place in the securities markets. However we believe that an effort must be made to develop a government administrative body which can act quickly and obtain immediate replies to inquiries. This body must also be able to determine its views quickly when it does intervene in market events such as takeovers. Self-regulatory bodies are nevertheless required to discharge some functions calling for speed and flexibility.

To sum up, your Committee is convinced that self-regulatory bodies such as the City Panel are not the whole answer to the problem of the regulation of the Australian securities market. As a result of our extensive experience in examining a wide range of securities transactions, we consider that plenary government investigatory power and governmental enforcement of rules is necessary to deal with the market practices which have been occurring in Australia.

Despite the view we have just expressed, we stress that there will be a substantial role and need for self-regulatory bodies in the system of securities regulation which we recommend. Indeed, we see this self-regulatory function as an essential ingredient of a total regulatory system.

There are several reasons for recognising and encouraging self-regulatory bodies:

(i) A self-regulatory body can be complementary to a government body. A regulatory system of several different types of bodies is thereby created and any one of those bodies may stimulate the others to improve their performance. A self-regulstory body is more likely to act expeditiously and effectively because of the possibility that the government body will intervene if it does not. On the other hand, if one body does not have a desirable level of expertise, understanding, will to act, or effectiveness, the others may. Thus, it was apparent from our examination of the American system that the surveillance of trading in stocks on the New York Stock Exchange was done and best done by the Exchange's executive staff who had the necessary familiarity with the details of the market place. However, this surveillance is undertaken in accordance with general principles initially formulated by the Securities and Exchange Commission, which itself maintains a continuing interest in the area.

(ii) A self-regulatory body should be capable of laying down broad standards of behaviour and competence for its members and of enforcing these standards. A governmental administrative body may prefer to proceed on the basis of more closely defined rules. The two procedures are complementary.

(iii) Self-regulatory associations can best perform a good many detailed and routine tasks. For example it may be appropriate for them to conduct examination of brokers' and underwriters' finances or carry out, subject to requirements with respect to reporting to a government body, surveillance activities in the market. The relationship between the S.E.C. in the United States and the New Yolk Stock Exchange is so based.

Proposal for a Joint Commission

One possible form of a national regulatory body would be a national commission created by joint action of the States and the national Parliament. A proposal for such a body was put forward by the Eggleston Committee. As we noted earlier, that proposal was made before the decision of the High Court in the Concrete Pipes Case at a time when there was considerable doubt about the extent of the power of the national Parliament to legislate. The proposal was rejected by the Standing Committee of

Attorneys-General. More recently action has been taken by three States to set up a joint commission for those States only.

We wish to make it clear that in advocating the establishment of a national regulatory body we are not in fayour of such a joint commission, particularly not one which involves the concept of continuing responsibility to all the governments concerned. Such an arrangement would seriously endanger the ability of the system of regulation to adapt speedily to ever-changing circumstances and standards. The experience referred to earlier has shown how difficult it is to secure the agreement of all seven governments.

It is difficult to envisage the relationship between the joint commission and the various State and national Ministers. Would the body be responsible to more than one Minister? How and by whom would ministerial discretions be exercised? How would arrangements be made for the consideration and, if thought necessary, the disallowance of rules by the parliaments involved? Which would be the appropriate courts to deal with litigation arising? We might mention in passing that the current proposal for an inter-State commission for three of the States not only raises these questions but it fails to meet the basic need for a national regulatory body. National regulatory action is preferable.

Action by the National Government and its Objectives

Our recommendation is that the new national regulatory body should be established by the Federal Government. It is clear from the powers given in the Constitution, that this government was created to meet national needs relating to 'foreign corporations and trading or financial corporations ...' and interstate and overseas trade and commerce. It also has responsibility with respect to the use of postal, telegraphic or telephonic services, the Territories, insurance and banking other than State banking. In our view the time has come for the Federal Government to step in to assume responsibility for seeing that the securities market is properly regulated.

This legislative action should be in pursuance of two broad, sometimes conflicting, objectives of national policy.

(i) The first is to maintain, facilitate and improve the performance of the capital market in the interests of economic development, efficiency and stability.

(ii) The second is to ensure adequate protection of those who invest in the securities of public companies and in the securities market.

The securities market must, in relation to the first of these aims, be judged by how efficiently it enables capital to be raised for productive purposes and by its capacity to provide a ready market in securities after they have been issued. Over the long run, a wide range of factors must be taken into account. Excessive cost to the venturer or inefficiency in raising capital is undesirable. Excessive cost or inefficiency may stem from an excessive burden of fees, documentation and delays imposed by government authorities or by self-regulating bodies such as the stock exchanges. It may also be associated with the charges and practices of financial intermediaries such as underwriters, brokers to an issue, investment advisers, or brokers acting as agents or dealing as principals. Excessive charges may also be attributable to monopoly power and to restrictive trade practices. The evidence with respect to the profits and operations of brokers discussed in Chapter 5 suggests that the securities industry, at least in that section of it having memberships of stock exchanges, is insufficiently competitive. Government policy with respect to the securities market must, therefore, be concerned with these matters.

16.15

The opponents of the introduction of a national system of securities regulation have repeatedly expressed concern or alarm over the cost that will thereby be incurred by companies, investors or taxpayers. We do not think these views should prevail. They are, to some extent explicable as attempts to forestall legislation requiring fuller and more accurate disclosure of facts about listed and other companies.

A national system of regulation should be able to operate more efficiently and cheaply than the present system of eight separate administrations. Some of the budgets of the United States S.E.C. have been available to us and we have noted that in 1970 the S.E.C. showed its 'actual' cost as $US 21.9 million. This appears to be a modest sum having regard to the size of the United States securities market and the high quality of the work by the S.E.C. The figure is low by the standards of American independent administrative agencies. Compared with the costs of running Companies Offices in Australia, the cost of the S.E.C. is also low, after allowance is made for the difference in size of the two securities markets, though the Companies Offices do perform functions not carried out by the S.E.C. We agree that, when possible, the costs and benefits of proposed changes in the regulations should be carefully weighed before they are introduced. However, it will often be difficult to quantify the benefits which are obtained from introducing legislation designed to protect investors. The point to remember is that unless investors continue to have confidence in the integrity of the share market they must be expected, in the long term, to direct their funds elsewhere, thereby reducing the flow of financial capital to companies through the share market.

The opponents of a national system of securities regulation for Australia have also expressed anxiety over the manner of implementation by the United States S.E.C. of the rules under the Securities Act of 1955 covering registration statements.

We have investigated the cost to an issuer of compliance with the requirements and consider that the concern over the cost has been exaggerated. However, there has been a tendency, in our view, for the documentary requirements to be excessive and we recommend that consideration be given to avoiding a similar problem in Australia. This will involve careful attention by the national regulatory body.

The second objective of national legislation - the ensuring of adequate protection to those who invest in the securities of public companies and the securities market - has been a major theme of company and securities laws in Australia. However, more effective action is called for to reduce the incidence of sharp practice and incompetence. Additional protection is needed against company insiders and others who take unfair advantage of information which is not generally known to the market. Investors and the market should be more accurately and expeditiously informed of material events concerning listed companies. Further government intervention is needed to regulate the activities of brokers and other financial intermediaries to ensure that they are competent, that they adequately serve the interests of their clients, and that clients' funds are protected. The stability and orderliness of the market is of particular concern to thousands of Australians who, during their working lives, have, directly and indirectly, invested their savings in the market with the intention of drawing on them in their retirement. It is important that the market be free of abuses which may disadvantage these investors, and that it offer to them in their retirement competent and efficient agency and other services. We have heard disquieting evidence of failure in these respects.

We also attach importance to the role played by the market in the encouragement and facilitation of ownership by the public of equity in Australian business. Given a sounder market, there could be a greater flow of domestic savings into the purchase of shares in Australian companies. We believe consideration should be given to providing individual investors with additional opportunities to acquire shares in new issues of sound public industrial and mining companies and not only in the new issues of speculative ventures. We have been disturbed about some of the methods used by brokers and underwriters in distributing so-called public issues among investors. The influence in the market of the large institutional investor is a question requiring a separate study. However, in this context we note that attention should be given to the rapid growth of private share issues to these institutions. Many individual investors have complained to us that the new issue market in sound industrial shares is being dominated by the institutions, and that smaller investors seldom have an opportunity to acquire any of the shares placed privately.

The Case for a Commission

We consider that there should not only be a single, national, governmental, regulatory body to administer the proposed legislation but that it should be a commission in the nature of a statutory corporation rather than a body set up within a Department. There are several reasons for this view.

First, the regulatory body will need to exercise rule-making powers, to exercise discretionary powers, to carry out investigations involving the hearing of witnesses and to institute and conduct proceedings. A commission is the appropriate body to perform these functions.

Second, the national body should be administered by people of outstanding ability. They should be given the degree of independence in decision-making and the status which goes with the office of commissioner. It will also be sensible to attract people for fixed periods from industry or professional life and to pay them appropriate salaries. It is best that the commissioners be directly appointed by the government of the day and that their salaries and conditions fall outside normal public service gradings.

Third, the task of administering the proposed legislation will be considerable. It will involve the exercise of important discretions, and will demand a high level of expertise and understanding. It would be unrealistic to expect a Minister or Head of an existing Department to give the necessary attention to the detailed decision-making, discretionary and administrative responsibilities involved. In addition an administration under a Minister is generally subject to more frequent changes in its head than a Commission, and consequently to more frequent changes in political outlook. It is in keeping with general tenets of good government and with developments in areas such as central banking, trade practices and consumer protection that a commission be created.

We note that, after difficulties with their stock markets revealing the need for additional regulation, commissions have been created in New South Wales and Queensland. Securities commissions also exist in Canada in the provinces of Ontario, Saskatchewan, Alberta, British Columbia and Manitoba. In the United States there is the federal S.E.C., and there are many State commissions.

Fourth, a commission with a separate statutory status can develop the tradition, fund of expertise, authority and morale which can assist in the maintenance of a high quality of administration.

Considerations of this kind were referred to in the first interim report of the Eggleston Committee in relation to its recommendation of a Companies Commission, 490 One very important advantage which will flow from the establishment of a Companies Commission is that there will exist for the first time in this country a permament and responsible organisation, which will develop a fund of knowledge and be in a position to give prompt and authoritative advice to governments as to desirable amendments in the future. The cumulative experience of an authoritative body which is regularly dealing with problems arising under the legislation will be of very material assistance in the essential task of continual review of the statutory requirements.

Fifth, in the area of securities regulation and the administration of public company law, which involves the financial community and large corporations, influential pressure groups tend to operate. If the legislation is administered by a commission, there should be less scope for variation, anomalies and lapses in the regulatory body's work as the result of political influences.

This is not to say that the Commission will not be responsible to Parliament and to a Minister, or that the relevant Minister will not exercise significant powers in the area.

Accordingly it is recommended that the proposed legislation create a commission as a statutory body corporate with perpetual succession, an official seal, capacity to acquire, hold and dispose of real and personal property. It should be authorised to make applications, institute proceedings and bring actions and to be sued, all in the official name of the commission.

The usual provision should be made that courts, judges and persons acting judicially take notice of the seal of the commission affixed to a document and presume that it was duly affixed. Similarly, notice should be taken of the official signature of any person who holds or has held the office of commissioner, registrar or deputy registrar within the commission.

We recommend that the commission's official name be The Australian Securities Commission.

Some Features of the Proposed Commission

The Commissioners

The question arises whether there should be one commissioner and some deputies or several commissioners and one chairman. A further question concerns the number of commissioners to be appointed. We have noticed that several Australian statutes provide for one commissioner and several deputies. As a result of the Ash Report on Selected Regulatory Agencies, 1972, there has also been discussion of the advantages of one commissioner for the United States S.E.C. However, we think there should be several commissioners of similar status and one chairman. We believe the commission's wide range of functions should be carried out by different divisions in order to develop and preserve the special qualities needed for each function. These divisions should be established administratively rather than by legislation, and we anticipate that they may be altered in the light of experience. There would be advantages in each major division having the services of a full-time commissioner of equal status with the others. In our view, one commissioner could not accept proper responsibility for all functions or hope to give attention to each of them. Many special skills will be required in carrying out the commission's functions. If there are several commissioners there will be opportunity for people of different expertise and experience to contribute to the commission's role. We would, however, expect the commissioners to act together in making major decisions affecting the whole commission.

The number of commissioners we envisage is three. Though it may prove desirable in time to appoint more, we think that the number should be fixed by statute. If necessary the statute can be amended. To leave power in the executive to appoint any number of commissioners is, in our view, undesirable. It would create a possibility of 'stacking' the commission and weakening its immunity from political pressure.

Accordingly, we recommend that the legislation provide that the commission consist of three members to be appointed by the Governor-General and that the Governor-General appoint one of the commissioners to act as chairman of the commission.

We recommend that each commissioner be appointed for a period not exceeding seven years, specified in the instrument of the appointments and be eligible for re-appointment subject to a rule that no appointment for a full term be made after the age of 65. However, the first appointments should be for three, five and seven years respectively, in order that one commissioner retires every alternate year.

We recommend that the commissioners serve in a full-time capacity. We do not favour part-time commissioners. Each commissioner should be immune from dismissal, subject to good behaviour and competence. There should be a right of resignation.

Provision should be made for appointment by the Minister of an acting chairman. The quorum for decision of the commission should be two. The commission should be given the power to determine the arrangement of the business of the commission and of the divisions which shall exercise the functions of the commission and to delegate functions, including hearing and investigatory functions, to particular commissioners, officers of the commission or other persons appointed for a particular purpose. The latter power is important to enable the appointment of legal practitioners or accountants to conduct investigations and of experts to assist in the carrying out of special studies or inquiries.

Considerations Relevant to the Choice of Commissioners

There will no doubt be considerable advantages from the point of view of continuity of dealing with the government, and of ensuring objectivity, in having at least one leading public servant in the position of commissioner. But we think it most important that persons be appointed as commissioners who have had experience in the securities industry, or corporate activity, or the related professions. An understanding in depth of the securities market and of public company affairs is of particular importance. In our view, one of the major reasons for the failure of effective government action with respect to regulation of the securities industry has been inadequate understanding of the securities market on the part of State administrations and, to some extent, even on the part of persons from the professions who have been called on to participate in law reform activities. Some sections of the financial community have been able to take advantage of this lack of first-hand knowledge. It is important that the defect be rectified. The fact that commissioners can be appointed for a term of up to seven years and will not be subject to normal public service gradings should facilitate the appointment of suitable persons from business or the professions.

The commission should not be entirely composed of persons with legal training and experience. At least one of the commissioners should be a person with experience in the securities market and securities industry, perhaps with training in business administration and law, accounting or economics, who has overseas experience in the securities industry, but who retains a critical perspective of corporate activity and an awareness of the public interest. There is a small group of such people in Australia. It would be desirable to complement such a commissioner with persons more concerned with legal and accounting principles, with the economics of capital market regulations and especially with investigation and enforcement. Such persons are important to ensure that the commission does not become industry-dominated.

Their Remuneration

We recommend that the Act provide for the commissioners to be paid remuneration at the rates and with the allowances which Parliament provides. We consider the salaries should be competitive with those offered by the self-regulatory organisations within the securities industry and not excessively below those offered in business. We believe that it will be possible to attract people of outstanding ability, in practical affairs who have an interest in the public good and some desire for a term of public service.

Freedom from Conflicting Interests of Commissioners and Staff

It is important that the commissioners and other officers of the commission be free from conflicting interests. Accordingly, we recommend that the commissioners, registrars, officers and employees of the commission be prohibited from having an interest, direct or indirect, in a company or undertaking where that may conflict with the role of the commission. If the interest is held prior to appointment or devolves on the person concerned by way of succession or gift it should be disclosed to the Minister, in the case of the commissioners, and to the commissioners, in the case of officers or employees, and be disposed of prior to acceptance of appointment or as soon as practicable thereafter.

Interests of members of the person's immediate family should similarly be disclosed. In the event that arrangements satisfactory to the Minister or commissioners (as the case may be) cannot be arrived at, the offer of appointment should be withdrawn, or where the interests accrue or the person becomes aware of them after appointment, the appointment should be subject to termination.

This should not prevent holding assets in the form of government securities or land, or other property not in the form of company securities or 'interests'.

Trading in shares or other securities by any commissioner, officer or employee of the commission or trading on behalf of such a person should be forbidden.

The Staff

We have already referred to the great difficulty experienced by the State companies administrations in attracting well-trained staff and persons with previous experience in corporate activities or the securities industry. The best of the State administrations have managed to attract some persons with training in accounting. They have had difficulty in retaining them. They have had little success in attracting lawyers, and this is one of several reasons for the inadequacy of enforcement action. Low salaries have been a factor. The dull, routine nature of many of the tasks has also been significant.

With the establishment of a national commission every effort should be made to ensure that the situation changes. The routine tasks should be substantially separated in a registry, or performed so far as possible with the aid of computers and machinery. It should be recognised that the commission's prime functions are concerned with the formulation of regulations, administrative policy and proposals for legislation, with the evaluation at an expert level of disclosure documents and situations and with effective methods of detection, investigation and enforcement. A body of experts with a wide range of training and experience is required.

The United States S.E.C. has generally maintained a high morale and level of expertise and has enjoyed the confidence and respect of the American investor and securities industry. That agency is not a large one, having regard to the size of the American securities market. Many of the tasks of administering regulations on brokers, dealers and advisers are performed by self-regulatory associations such as the National Association of Securities Dealers and the national exchanges. It appears that the S.E.C. has concentrated upon employing able young lawyers and that this policy has been successful. We have also observed that there is a group of highly-skilled senior officials who have remained with the S.E.C. and who have a thorough understanding of the markets.

We consider that there are some lessons to be learnt from the American experience, though we believe that some of the emphases in the Australian commission should be different. For example, we do not believe that there should necessarily be an almost exclusive emphasis on recruitment of young lawyers. People should be sought who have the skills and training necessary for different tasks. Thus if possible, it would be desirable to attract to the enforcement and prosecuting area, lawyers with some experience in litigation, even advocacy. But skilled investigators may come with other qualifications and experience. For the formulation of policy and proposals, we think there should be some economists. And, in the scrutiny and treatment of prospectuses and other securities documents, training and experience in securities analysis, accounting and particular fields of expertise such as geology may prove valuable.

It is important that the commission have on its staff some persons who have experience and understanding of corporate affairs and the securities industry.

<u>A Central Office and its Location</u>

Various suggestions have been made as to where the commission should be sited. Canberra, Melbourne and Sydney have been mentioned as possibilities. But wherever the commission is situated facilities will be required for the receipt and searching of documents. The commission will also need to keep in contact with the stock exchanges, securities industry and corporate community in the various State capitals and perhaps in other major centers. For these reasons, the commission Will need to maintain regional offices.

However, a central establishment will be required where the processes of consultation, clearance and co-ordination of investigation and other work can take place. We have heard suggestions that it should be situated in Canberra in order to give it detachment, perspective and insulation from the subtle influences of the financial world. We are, however, opposed to the establishment of the commission in Canberra, at least at this stage in Australian history. We think it should be in close contact with the market place. The commission will have some special responsibilities requiring more awareness of day-to-day market developments than may be the case with the Trade Practices Commission for example. If it is established in Canberra we think it will be more difficult to attract suitable commissioners and staff. There will be a tendency for it to be staffed by career public servants who have had little opportunity to become intimately aware of what is occurring in the securities market.

We find little substance in the proposition that Canberra possesses the virtue of compromise between Melbourne and Sydney.

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INDEX OF WITNESSES

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*Submission incorporated in public evidence