THE BRITISH STOCK EXCHANGE DEFENDED: A REPLY TO SEÁN CRONIN

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In a recent Libertarian Alliance piece (*Government Regulation is Government Monopoly: The Examples of British Agriculture and the British Stock Exchange*, Economic Notes No. 79) Seán Cronin identifies British agriculture and the British Stock Exchange as two examples of monopolies causing great harm. I focus on the second of these two examples because I think that Cronin is right about agriculture. In the case of the stock exchange, however, his argument that the exchange does great harm is wrong at almost every turn. Moreover, I question whether the very things which he attacks and attributes (incorrectly) to the monopoly stock exchange should actually be regarded as abuses at all.

Cronin argues that much of the evil in this country can be traced back to one monopoly alone — that of the stock exchange. Indeed, he suggests that this is the most insidious of all monopolies. Among the abuses generated by the institution he includes golden parachutes, three year rolling contracts, and the fees charged by merchant banks and stockbrokers. (He also attacks those favourite scoundrels the estate agents and the lawyers for their part in similar abuses.) It is suggested that these things are tolerated because individual shareholders are powerless to bang the table within the company boardroom. This is somehow thought to be a direct function of the monopoly exchange which has raised the cost of selling shares to prohibitive levels and thereby made it harder for an investor to vote with his feet. I will treat each stage of the argument in turn.

THE GOLDEN PARACHUTE

The first example of abuse by senior managers is the golden parachute. The "parachute" is the arrangement whereby the chief executive (of a company which has done badly) can be fired and still receive a payout of hundreds of thousands of pounds — often more. The very existence of the parachute upsets Cronin:

> Few people object to Richard Branson making his money but this sort of thing sticks in the throat of even the most committed free-marketeer.

What his grievance ignores is that no-one really knows for certain whether a given company will do well or not. Actually, insofar as there is no reward without risk, this uncertainty is what attracts shareholders to put up the money; the shareholder plans to make a fortune — but he runs the risk that he will lose every penny.

The manager, likewise, is aware of these risks and needs to plan for the event that his company does extremely badly. In fact, managers have an especially strong need to provide for their financial security; they may find it hard to secure another job after presiding over a corporate disaster. Given our limited knowledge of the future, it is obvious how arrangements such as the golden parachute arise in free markets. Many managers would refuse to work in industry without a parachute and I would certainly refuse to work in the square mile without one.

ROLLING CONTRACTS

Two factors are identified in the explanation of abuses such as the golden parachute. The first factor is conspiratorial: chief executives are said to sit on each others' boards and vote each other cushy deals. Given the size of the average company boardroom in contrast with the vast number of companies — domestic and international — listed in the UK, and given also the intense rivalry among the executives of competing companies, it is clear that such a conspiracy could exist only in the loosest possible sense.

The second factor identified is a legal one in the shape of the three year rolling contracts which company directors can sometimes negotiate. The three year roller is the arrangement whereby a director is hired for three years into the future — continuously updated. The fact that incompetent directors can be terminated only in tandem with compensation for the loss of three years' projected earnings once again sticks in the throat:

> No non-executive company employee can come up with such a heads-I-win-tails-you-lose employment contract, not even in the heyday of the unions.

(This claim is false by the way. A number of colleagues, both at my old firm and at my new employer, have enjoyed contracts of this nature. Not all of us have occupied an executive position, nor was any of us helped by a union!)

THE FUNDS REMAIN SILENT

It should, of course, be conceded that the City is an unusual place. But the point made earlier, in defence of golden parachutes, applies equally strongly in the case of three year rollers: employees with risky jobs — whether in industry, in stockbroking, in football, or in anything else — are likely to negotiate contracts to protect themselves in the event that they should lose employment. Contracts of this nature are inevitable in any sort of free market.

Cronin finds it hard to understand that these kinds of contract can be drawn up by mutual agreement. On the contrary, he seems to suggest that this kind of arrangement survives purely by default:

Economic Notes No. 84

ISSN 0267-7164 ISBN 1 85637 443 2

An occasional publication of the Libertarian Alliance,
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> So when this kind of thing happens why on earth can't we just phone up and say "do that and I'll sell my shares"? Because we can't own shares directly.

This is a strange and clearly false claim to which we will return. But the question is nonetheless an interesting one. The big pension funds — such as Gartmore, Mercury, Schroders, Phillips and Drew — are quite at liberty to phone up chief executives and threaten to sell their holdings if they believe that arrangements for remuneration are excessive. The fact that they usually reserve this right is telling: a hundred thousand pound payout might be a subject of some interest (or envy) to a reader of *The Guardian* but it makes not a jot of difference in the context of a public company whose annual costs may run into billions (and whose profits may well constitute hundreds of millions).

So the funds remain silent. They may even reason that parachutes, three year rollers and so on are a relatively low price to pay to find the right management. And as a matter of fact, British captains of industry are rather cheap compared to their American counterparts.

INTERMEDIARIES

Although the funds own the majority of shares in the UK market, millions are held directly by private investors and Cronin's claim that "we can't own shares directly" is quite false. He does concede in a footnote that you can arrange to *buy* the shares of a PLC directly from their current owner:

> But the company doesn't have to recognise the sale unless it's been registered by the company registrar, who can charge you for doing so. And whenever you sell shares you pay stamp duty, a percentage of the value of the shares. So the more your shares increase in value, the more it's going to cost you to realise that increase in value.

It would appear that there is a confusion here between the act of buying or selling and the act of ownership itself. It is as if one were to conclude from the number of estate agents in this country, and from the difficulties of trading houses directly, that there was no private property in the UK.

In fact, even the weaker and different claim — that we can't *buy* or *sell* shares directly — is not strictly true as the footnote above makes clear. The analogy with the housing market is again revealing: I could spend my Saturdays standing outside my house looking for the odd passer-by who might be interested in buying my flat. And on Sundays I could walk the streets of Notting Hill — knocking on the doors of houses which looked interesting and perhaps making the occasional offer if I found an available property. I could indeed buy and sell property directly in this manner but it would be a ludicrous way to proceed. As in many areas of our complex economic life, there is a role here for the broker — in this case the estate agent.

Cronin also bemoans the cost of using these intermediaries. Stockbrokers generally charge 0.2% commission while estate agents charge a full 2%:

> It's as if you were legally compelled to pay someone else every time you wanted to buy something in a supermarket.

Unfortunately, this particular example does the argument more harm than good. Consider: It is now very difficult to purchase a packet of corn flakes directly from Kellogg's; far more likely you will buy cornflakes from Tesco. One consequence of this is that you *do* pay someone else every time you buy something from a supermarket — the retailer plays an intermediary role here between the wholesaler and the public and it is his mark-up that you pay. Furthermore, the role of the retailer has nothing to do with legal compulsion and everything to do with the division of labour and economies of scale which have encouraged the development of intermediaries in free markets.

And so it is with the Exchange. The fact that most investors have to hire brokers to buy and sell shares for them is no more an indictment of the stock market than estate agents or food retailers are an indictment of their respective markets; on the contrary, intermediaries are what these markets are all about!

THE BUSINESS OF CERTIFICATION

The government-backed Stock Exchange provides obvious liquidity for investors who wish to trade. It would, of course, be preferable to see the Exchange outside of government ownership and in private hands — in the same way that I would prefer restaurants to be certified by Egon Ronay rather than by the health inspectors. But the business of certification is in itself a perfectly legitimate one. The government doubtless does an inefficient job of this in terms of overcharging for Main Board listings and for compliance but these expenses are, in principle legitimate ones which any company would expect from any conceivable stock exchange.

The Exchange already has to compete, to some degree, with the junior exchanges at home (such as the Alternative Investment Market) and, more significantly, with the massive exchanges abroad (in New York and Frankfurt, for example). And all its customers retain the ultimate right — to remain private.

Again, it would be nice to see the Exchange subject to truly competitive pressures in the way that Egon Ronay has to compete with Michelin, with word of mouth, and so on. Perhaps then we would see the emergence of different exchanges reflecting different appetites for risk. Widows and orphans would gravitate to the exchanges with the most stringent listing requirements. At the other end of the spectrum, the red-blooded gambler might favour an exchange with no listing requirements at all. The possibilities are interesting — but in a country where our education and health services are still provided by state monopolies the debate is esoteric to say the least.

PART OF THE CAPITALIST LANDSCAPE

It is argued, finally, that the Stock Exchange monopoly reduces competitiveness and national economic growth while it increases unemployment since "around 10% of money raised by a company on the Stock Market will go on the cost of raising it". Perhaps this percentage could be reduced if the Exchange were forced to compete even more vigorously with other exchanges but ultimately the cost of raising capital can never be zero.

London's square mile, for all its faults, remains second only to Wall Street as one of the greatest wealth-generating engines in human history — a meeting place for aspiring companies and aspiring investors not to mention a few lucky intermediaries such as myself. The fees collected by the merchant banks, like the commissions earned by stockbrokers and estate agents, and most of the other "grave abuses" detailed by Sean Cronin, are simply part of the capitalist landscape. Those who do not like the view should perhaps contemplate a more comprehensive change of scenery.