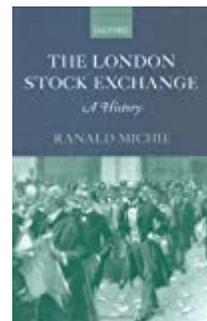




Ranald C. Michie. *The London Stock Exchange: A History.* Oxford: Oxford University Press, 1999. xiii + 672 pp. \$110 (cloth), ISBN 978-0-19-829508-2.



Reviewed by Larry Neal (Department of Economics, University of Illinois)

Published on EH.Net (August, 2000)

Among financial historians, it is now commonplace to regard the emergence of today's global capital market as a resumption of the progress that had been made toward creating a global market in goods, labor, and capital in the period from 1850 to 1914. Ranald Michie, the pre-eminent historian of the London Stock Exchange in that bygone halcyon era, presents the story of how the London Stock Exchange rose to preeminence in that earlier international capital market, but then suffered through the disruptions of the international economy created by two successive world wars and the financial crises that followed them, and is now still struggling to retain a reputable place in the new global capital markets that have emerged over the past thirty years. Written on the basis of an intensive examination of the records of the London Stock Exchange, his work will now be the standard reference on the London Stock Exchange, replacing old classics such as E. V. Morgan and W. A. Thomas, *The Stock Exchange: Its History and Functions*, (London, 1961), and even Michie's earlier work, *The London and New York Stock Exchanges 1850-1914*, (London, 1987). The timing of its appearance is especially fortuitous as the current members of the London Stock Exchange decide how to vote in September 2000 about the proposed merger with the German stock exchange. Will the smaller members lose their livelihood from the competition of the more efficient German firms? Or will the merger preserve their

incomes from the competition of electronic market makers not constrained by the rules of a formal exchange? Or will the largest firms be willing to buy them out on favorable terms in any event?

These are the questions today, but they have been faced in much the same terms any number of times over the past two hundred years, as Michie documents. The answers, though, have varied depending on both the nature of the external competition and the nature of the internal composition of the exchange. Michie argues that his kind of study, focusing on the decisions taken over time by the members of the London Stock Exchange, can reveal much about the role of the financial system in shaping the course of the real economy. It is not the securities market in Britain as such, then, that concerns him, but rather the specific role of the self-governing organization called the London Stock Exchange in the securities market. This is certainly a worthy endeavor and modern finance scholars are increasingly concerned about the implications of what they call "market microstructure" in determining the efficiency of price discovery processes as well as overall efficiency in financial intermediation. For them, Michie describes and appraises the creation, operation and evolution of the microstructure of what is still one of the world's leading stock exchanges and was the undisputed leader during the gold standard era.

He does not, however, deal with these arcane issues of market efficiency, to the disappointment of some readers, but no doubt the relief of most. (The awkward term “microstructure” never appears in the 642 pages of text.) But neither does he entertain with stories of rascal behavior by the more opportunistic participants of the “House,” to the disappointment of most readers and no doubt his publisher hoping for more robust sales. Rather, he concludes each chapter with a table showing the number and capitalization of the securities listed on the London Stock Exchange for a benchmark date. These together show the changing scale and scope of the exchange’s market over time. This is a solid work of original historical research that gives the reader many interesting insights and raises important questions for practitioners and policymakers as well.

Michie begins his story, “From Market to Exchange, 1693-1801,” with an overview of the rise of an informal, unorganized, secondary market in government debt. This begins, in his view, in 1693 with the establishment of permanent debt that could be transferred. As the amount of debt increased with each successive war, so did the number of investors, encouraged by the government’s ability to continue servicing at least the regular interest payments promised on the debt issues. Gradually, specialists arose, both brokers and jobbers, both very important to the operation of an efficient secondary market for any set of products. Brokers made their money from commissions they charged to their principals, who desired to buy or sell an amount of a particular security within a specified price range. Jobbers provided the brokers the counterparties to their principals, offering to sell to their buyer or to buy from their seller the particular security. They made their money on the difference between the prices they bid or asked, and saved the broker the time and expense of finding a specific counterparty to his original client. Both made more money, the greater the volume of transactions. Brokers made a commission charged to their principals; jobbers made a “turn” on the bid-ask spread always intending to buy low and sell high. By the end of the eighteenth century, the number of investors was large and a number of specialized brokers and jobbers seemed to be making a living from their respective trading activities. Nevertheless, asserts Michie, this was just a market, not an organized exchange that could affect by its own rules and enforcement decisions the way the security market would develop in the future. In 1801, however, the informal London stock market ceased to be shaped strictly by outside forces and henceforth could determine in part its own

destiny through the decisions taken by its governing bodies. These were the Committee for General Purposes for the Members and the Trustees & Managers for the Proprietors.

How they operated vis-a-vis each other to solidify the tradition and prestige of the “House” is detailed in “From Money to Capital, 1801-1851.” Readers familiar with Michie’s earlier comparison of the London and New York stock exchanges, the two classic examples of financial capital marketplaces, will find a familiar theme in his emphasis in this book upon the importance of the governance structure of the London Stock Exchange as it coped with the successive changes in monetary regimes, government controls and policies, new communications technologies, and international and domestic competition. Responding to the pressures of war finance in 1801 at the outset of the Napoleonic Wars with France, one group of traders became the Proprietors of the building that housed the market place for the Members engaged in actual trading. The Proprietors, as owners of the market place, but not of the products of the market place, were strictly interested in maintaining a large membership paying annual subscriptions for the use of the facility while keeping operating costs as low as possible. The Members, as users of the market place, were concerned strictly with generating a large volume of trading while keeping their own costs of business as low as possible. Faced with outside competition from time to time, the Members would try to restrict access, while the Proprietors would try to co-opt it into the House. Members, however, had complete control over who could become a Member, although Proprietors set the annual entrance fee that individuals had to pay to take up their membership and determined the hours of operation and physical amenities provided. Once in place, this method of operation proved self-sustaining and it endured through all the travails and opportunities that ensued over the next two centuries.

In the first half century, the governance structure was challenged by two shocks, the brief but intense interest in foreign government debt and foreign mining shares in the early 1820s and then the longer and even more intense investor enthusiasm for railroad securities starting in the late 1830s. In both cases, the users of the exchange wanted to keep out competition by traders specializing in the new securities but the owners of the exchange accommodated them as soon as possible to prevent an alternative exchange from arising in London. The resulting expansion of business benefited all members and solidified their operating rules and governance procedures.

In the rest of the nineteenth century, which Michie labels "From Domestic to International, 1850-1914," the British success with financing domestic railroads led to providing finance for foreign railroads and then for large commercial and industrial firms both at home and overseas. The continued expansion of the number and variety of securities listed on the exchange led to enlarged memberships and increased pressure on the physical facilities of the exchange. To finance a new building in the 1870s, the Proprietors increased fees on the Members, who responded by demanding more voice in management. The conflicting interests were resolved through expanding the capital stock of the Stock Exchange by requiring all future members to become shareholders as well as subscribers. The number of shareholders grew, as a consequence, from only 268 in 1876 to 2,366 in 1914 so that there gradually occurred an overlap between Proprietors and Members. In his earlier work, Michie has argued that the increasing voice of broker members in the governance of the Stock Exchange was gradually undermining its flexibility in responding to competitive challenges and its responsiveness to technological advances in communications. Now, his appraisal is that the exchange was remarkably flexible and responsive, especially, one infers, by contrast with its continued dithering over the period 1945 to 1986, which came dangerously close to eliminating it entirely as an organization.

What accounts for this earlier success? Internally, one factor was that dual control by Proprietors and Members continued to be effective in offsetting tendencies towards restricting access to the exchange; another was the continued importance numerically of jobbers within the membership of the exchange. Externally, the most important factor was the central role played by the Stock Exchange in the money market of London. The ever-expanding joint stock banks in London found that their loanable funds could be employed profitably for short periods of time by lending to so-called money brokers who were members of the Stock Exchange. They, in turn, could lend on security of shares and stocks held by jobbers to allow them to settle differences at the fortnightly settlements or to continue their positions to the next account. Specialization in function within the Stock Exchange thus occurred that allowed further specialization in function among the financial intermediaries of Lombard Street. These nested specializations increased efficiency in the use of funds by all concerned. They also allowed, however, increased efficiency within the growing number of provincial stock exchanges, who could tap into the London money market easily through the

branches of the joint-stock banks.

Whatever the dynamics of the emerging structure of finance and industry would have created for the future of the British economy, the impact of World War I changed everything, and mostly for the worse in Michie's opinion. First of all, it eliminated the foreign business of the Stock Exchange bringing that under the control of the Treasury, now concerned only with raising money for war finance. Second, it eliminated the money market role of the Stock Exchange by eliminating dealing in options and even for account. Finally, it created a comfortable source of easy commissions by the huge increase in government debt traded on the Stock Exchange. Wartime restrictions on membership created by military service for younger members and expulsion of foreign, especially German, members were formalized by rule changes when peace returned. Minimum commissions were rigidly enforced. In short, the war changed permanently all the external conditions that had created prosperity for the members of the Stock Exchange before the war. But it also strengthened the rigidity of internal rules that protected the incomes of the surviving members.

Michie then treats the interwar period in two separate chapters, "Challenges and Opportunities, 1919-1939," and "The Changing Market Place Between the Wars." The first chapter details how "the rules of the Stock Exchange, designed to create an orderly market, were increasingly used by the membership to limit the competitive environment within which they operated. This was true both in terms of outside competition, with restrictions on admissions, and internally, with minimum commissions and other controls. The end result was a lessening of those forces for change that had forced the membership in the past to respond to challenges and to seize opportunities" (p. 234). This is exactly the conclusion one expects, given Michie's earlier study. The second chapter argues that, nevertheless, the ossification of the Stock Exchange was not the key problem for the finance of British industry during the interwar period. Rather, the increased rate of taxation needed to service the huge increase in government debt, the decline of profitability of older industries, and London's diminished international role all limited the potential supply of finance, irrespective of the reduced efficiency of the Stock Market in providing financial intermediation. While researching the current book, Michie has become more sympathetic to the efforts of the Stock Exchange as an organization and more critical of the external forces that limited its potential service to the British economy.

In “New Beginnings: The Second World War, 1939-1945,” the changes that the exigencies of war finance had inflicted upon an unsuspecting and unprepared Stock Exchange in 1914 were now adopted quickly as a matter of course. The Stock Exchange willingly became an administrative arm of the government, helping the Treasury to market its burgeoning debt issues and receiving in turn the protection of the government against competitive forces in the government debt market. Dual control was finally ended informally, as the Committee for General Purposes for the users and the Trustees and Managers Committee for the owners were combined into a Council, dominated by the members, or users, of the Stock Exchange for the duration of the war. This streamlined governance structure made the postwar Stock Exchange an effective arm of the government, but ossified the responsiveness of the organization to the competition of provincial exchanges and of the joint stock banks in dealing on the securities markets in Britain. It did, however, enable the members to buy out the proprietors and formally end dual control in 1948. Thereafter, the business of the Stock Exchange was not to make a profit for the owners, but to render services to the existing members. On the expense side, however, it was committed to pay out 160,000 annually to buy out the previous Proprietors and committed to enlarging its salaried staff to carry out the regulatory functions it believed the government expected of it. On the revenue side, members were not willing to vote increased subscriptions fees, much less stock assessments, on themselves, especially as the incomes of many firms fell after the war.

“Drifting towards Oblivion, 1950-1959,” “Failing to Adjust, 1960-1969,” and “Prelude to Change, 1970-1979,” are the chapter titles that follow and they convey well the encompassing malaise that overcame the Stock Exchange and most of its members, steadily declining in number and consolidating into fewer and fewer firms in each succeeding decade. During the 1950s, however, the London Stock Exchange found a new role despite its hidebound governance and administrative structure. This was serving as a market place for the rising volume of domestic corporate shares. These were not, Michie argues, a new source of finance, but a substitute for business debt with fixed interest, which was increasingly unattractive to British investors in the persistently inflationary climate of the 1950s. These didn’t match in total volume the size of government debt, but in terms of trading commissions earned by member firms they were just as important as those earned on placing and trading issues of government debt. Moreover, government debt trading be-

came increasingly concentrated among fewer firms while corporate equities could provide niche markets for a variety of the member firms. In the 1960s, this trend established in the 1950s continued to the benefit of the Stock Exchange and its members. But it also elicited increasing interest from foreign investors, whose demands were quickly met by foreign firms, both banks and investment houses, located in London, rather than by the Stock Exchange. Further, provincial exchanges and non-member stockbroking firms found it easy to enter this growing market, especially as the Stock Exchange became increasingly restrictive in its listing requirements for corporate equities. As a quasi-regulatory arm of government, the London Stock Exchange felt it was important to protect outside investors from the risks of smaller firms in new industries, but this was precisely where the largest potential profits could be made. The circumstances of the 1970s at first confirmed the wisdom of this strategy to the leadership of the Stock Exchange when the equities market collapsed in 1974. This led to a formal merger with the provincial exchanges, enlarging the membership of what was now called the International Stock Exchange within the same rigid set of rules as before. The country jobbers were forced to become single-capacity brokers, so they helped strengthen the support within the membership for enforcing minimum commissions. Moreover, the Stock Exchange was now a much more effective regulator of the British securities marketplace. But the cost of this consolidation was that the Stock Exchange was further constrained from responding to challenges by foreign exchanges and firms, and from initiating or even imitating financial innovations taking place within non-member firms and the major financial intermediaries in the City of London.

The breakthrough that eventually led to the “Big Bang” (chapter 12) in 1986, the once for all elimination of minimum commissions and restrictions on the size and functions of member firms, Michie argues, was the elimination by the Thatcher government of exchange controls in 1979. Now the customers of the brokerage houses, increasingly the banks, insurance companies, and investment houses, could readily invest abroad with foreign exchanges and stockbroking firms. Foreign banks and brokerage houses in London could now bypass the high costs of the Stock Exchange without incurring the penalties imposed by exchange controls. The response of the Stock Exchange to this challenge was delayed until 1986, however, not because of the rigidity of the governance structure, but because of the Thatcher government’s attack on the privileges of the Stock Exchange brought before the

Restrictive Practices Court. While this action was on the docket, the Stock Exchange officers felt compelled to defend the entire corpus of Rules and Regulations that had accreted over the decades, according to Michie. Not until the case was dismissed by the government in 1983, did the officers feel free to move forward to modernize the rules of the Stock Exchange.

In the penultimate chapter, "Black Hole," Michie begins by stating that "On 3 March 2001 the London Stock Exchange, as a formally organized securities market, will have existed for two centuries." That, we now know, remains to be seen! Michie documents the difficulties faced by the venerable institution for survival, but seems to think they stem mostly from continued hassling of the securities market in general by government regulators. Given the City's success previously in attracting the business of foreign international banks, mainly to deal in the Euro-dollar and Euro-bond market that developed outside the Stock Exchange, the Big Bang's removal of restrictions on membership allowed the entry of the most innovative firms and practices from around the world. At his most optimistic, Michie opines, "In fact,

what emerged from Big Bang was akin to the dual control which had worked so well in the past, with responsibility now shared between the Stock Exchange, representing its members, and the regulatory authorities, reflecting the needs of the wider financial community" (p. 634). General readers could more easily share this optimism if they had confidence that the regulatory authorities would reflect the needs of the financial community rather than the needs of their political masters to be re-elected within five years. Indeed, Michie's final lesson that he draws from his historical account is "that self-regulation without monopoly power has produced the most satisfactory solution in the past. Otherwise governments operate to their own agendas, distorting the market and destroying innovation in the process, while self-regulating monopolies abuse their power for their own self-interest" (p. 642). The challenge is clear; how it will be met is not!

Copyright (c) 2000 by H-Net, all rights reserved. This work may be copied for non-profit educational use if proper credit is given to the author and the list. For other permission, please contact H-Net@H-Net.MSU.EDU.

If there is additional discussion of this review, you may access it through the network, at:

<http://eh.net/>

Citation: Larry Neal. Review of Michie, Ranald C., *The London Stock Exchange: A History*. EH.Net, H-Net Reviews. August, 2000.

URL: <http://www.h-net.org/reviews/showrev.php?id=4413>

Copyright © 2000, EH.Net and H-Net, all rights reserved. This work may be copied for non-profit educational use if proper credit is given to the author and the list. For other permission questions, please contact the EH.NET Administrator (administrator@eh.net; Telephone: 513-529-2850; Fax: 513-529-3309). Published by EH.NET.