SECURITIES EXCHANGES GUARANTEE CORPORATION

6 December 2011

Manager, Financial Markets Unit
Corporations and Capital Markets Unit
The Treasury
Langton Crescent
PARKES ACT 2600

Email: CFR-Review-FMI@treasury.gov.au

Dear Sir/Madam

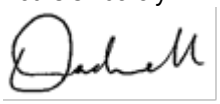
Council of Financial Regulators: Review of Financial Market Infrastructure Regulation

Enclosed is Securities Exchanges Guarantee Corporation Limited's (SEGC) submission in relation to the Council of Financial Regulators: Review of Financial Market Infrastructure Regulation October 2011 Consultation Paper.

SEGC's submission has deliberately been kept brief. We are happy to provide further comment by way of written submission or verbally in conference if this would assist you.

If you would like to discuss any aspects of this submission please contact me at michael.bradwell@asx.com.au or phone: (02) 9227 0423.

Yours sincerely



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Council of Financial Regulators: Review of Financial Market Infrastructure Regulation

SEGC Submission
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Introduction

This submission is a response by Securities Exchanges Guarantee Corporation Limited (SEGC) to the Council of Financial Regulators (CoFR) October 2011 Consultation Paper, *Review of Financial Market Infrastructure Regulation*. Further comment on any of the points raised in this submission, or on any additional points considered to be relevant to the consultation, can be provided on request.

SEGC is a company limited by guarantee and the trustee of the National Guarantee Fund (NGF) under the *Corporations Act 2011 (Cth)*. The sole member of SEGC is ASX Limited (ASX).

The NGF is a compensation fund available to meet certain claims which arise from dealings with participants of ASX and, in limited circumstances, participants of ASX Clear Pty Limited.

SEGC administers the NGF in accordance with Division 4 of Part 7.5 of the *Corporations Act 2011 (Cth)* and the *Corporations Regulations 2011 (Cth)* and holds the assets of the NGF in trust for the purposes set out in that legislation.

Details of the current SEGC Board are included with this submission.

Summary

- The first priority of the CoFR with respect to compensation arrangements should be the development of a clear framework for the circumstances in which the fund is applied and for whom.

- SEGC has robust governance arrangements and an experienced Board with a majority of independent directors.

- If perception is an issue in the context of a foreign acquisition of ASX or if other market licensees join the scheme by becoming members of SEGC, this can be addressed by putting in place a mechanism which provides for a wholly independent Board in that event.

Improvements to Part 7.5 compensation arrangements

The Consultation Paper has asked whether stakeholders see any areas in which the governance of the NGF, or other arrangements under Part 7.5, could be improved, and how?

The SEGC Board understands that CoFR has asked this question in connection with the potential for a foreign entity to acquire control of ASX, and perceptions of the independence or otherwise of SEGC and the NGF in that context.

The SEGC Board is strongly of the view that the first priority of the CoFR with respect to the NGF should be the development of a clear framework for that scheme:

- First, how the NGF as a compensation fund should operate – whether it should continue to operate within a strict legal framework as a statutory trust, or whether it should be operated along different lines, such as those of the Financial Ombudsman Service (FOS)?

- Second, in the context of the framework for the operation of the fund, what should be the circumstances in which the fund is applied, and for whom?

Operation of the NGF

The NGF as currently established is very different to FOS. It is a legal scheme closer in kind to a Solicitors Fidelity Fund. The NGF resulted from the merger of the State stock exchange fidelity funds, which were established from contributions by brokers, interest on broker moneys held with the exchanges, and interest and profits on investment of funds.

SEGC has made a number of submissions in 2002, twice in 2004, and in 2007 in response to various consultations relevant to the operation of compensation arrangements under Part 7.5 of the *Corporations Act 2011 (Cth)*. Copies of these submissions are enclosed, and some of the submissions – in relation to heads of claim and capping of claims – are restated below.

The SEGC Board notes that SEGC's 2002 submission included international comparisons with other investor compensation schemes, and encourages CoFR to conduct similar comparisons in connection with this review.

Heads of claim

Currently, the statutory framework for compensation arrangements for market licensees includes:

- Division 3 compensation arrangements, which apply to all current market licensees (including ASX in limited circumstances) and which, broadly speaking, are available to meet certain claims arising from fraud or defalcation of money or other property by a participant of that market.

- Division 4 compensation arrangements – i.e. the NGF – which currently applies only to ASX and which, broadly speaking, is available to meet certain claims arising from:
  - incomplete securities transactions (subdivision 4.3);
  - unauthorised transfers of securities (subdivision 4.7);
  - cancellation of certificates of title (subdivision 4.8); and
  - insolvent participants (subdivision 4.9).

There is no obvious rationale for maintaining these two very different sets of compensation arrangements. The original policy rationale is no longer relevant and it is confusing for investors.

In addition, while the structure and operations of the stockbroking industry has changed dramatically since the heads of claim for the NGF were established, the heads of claim have remained largely the same.

The SEGC Board strongly supports a thorough review of the heads of claim for compensation arrangements for market licensees. This review should not be limited to Division 4 compensation arrangements. The review should consider appropriate categories and levels of coverage having regard to today's service delivery landscape in the stockbroking industry.

Retail or wholesale clients?

Currently, the NGF covers both retail and wholesale clients. By contrast, Division 3 compensation funds apply to retail clients only. Again, there is no obvious rationale for maintaining this difference. As indicated above, the question of whether the NGF – and Division 3 compensation funds, for that matter – should apply to retail clients only, or to retail and wholesale clients both, can only be answered in the context of a clear framework for how the NGF as a compensation fund should operate.

We note that these questions also need to be considered in the context of changes to the structure and operation of the industry – and to its regulation. By way of example, orders executed on dark pools for wholesale clients are now required under the ASIC Market Integrity Rules to be reported to a licensed market. This potentially brings those transactions within the scope of the NGF.

Capping of claims

Currently, there is no capping of claims on the NGF, except to the limited extent that claims under subdivision 4.9 are limited to 15% of the minimum amount of the fund in respect of any insolvent participant.

By contrast, claims on Division 3 compensation funds can be – and generally are – capped.

The SEGC Board strongly supports the capping of claims on the NGF. The Board has previously supported a cap of $500,000 per claim (see enclosed March 2004 submission). The appropriate level could be determined having regard to domestic and international comparisons, and to the circumstances in which it is determined that the fund should be applied, and for whom (e.g. retail or wholesale clients).

Governance of the NGF

To the extent that there are issues of perception with respect to the governance of SEGC and the NGF, these can be addressed by reference to the facts.

First, the NGF is the only compensation fund for an Australian market licensee that is administered by an independent statutory trustee. All Division 3 compensation arrangements are administered by the licensed market that is required to maintain the arrangement.

Second, SEGC is regulated by the Corporations Act and as a company limited by guarantee must operate in accordance with its constitution. The Board consists of a majority of three independent directors, with two directors appointed by ASX as the sole member of SEGC and the operator of the licensed market to which the fund relates. The Board has an independent chair. Details of the current Board are set out below.

Public awareness of the NGF is raised through SEGC's dedicated website (which had 2284 page impressions from 926 unique browsers in the 8 months to the end of October 2011) and through the publication of SEGC's annual report.

Nonetheless, if further measures are considered to be necessary and appropriate in the context of a foreign entity acquiring control of ASX, then a simple amendment could be made to the legislation (with consequential amendments to SEGC's constitution) to provide that in that event, the two ASX-appointed directors would be replaced with independent directors appointed by the three existing independent directors.

In addition, the requirements in Division 2 of Part 7.4 of the *Corporations Act 2001 (Cth)* with respect to individuals involved in a market licensee or CS facility licensee could be extended to individuals involved in a compensation arrangement for a market licensee (whether a director of SEGC or an individual responsible for the administration and operation of a Division 3 compensation scheme).

The SEGC Board considers that there are significant benefits in the current outsourcing of support services (in particular, company secretarial, legal and financial services) to ASX Operations Pty Limited, including significant cost benefits, and access to specialised knowledge and resources which would not be readily available from other service providers. Nonetheless, recognising that there would be costs involved in changing the structural arrangements and potential increased costs in servicing the needs of SEGC, if it was considered that these services should be outsourced to other providers, this could be arranged.

SEGC Board

The SEGC Board currently consists of:

- Susan Doyle (independent)
- Ian McGaw (ASX appointee)
- Nancy Milne (Chair, independent)
- Lynn Ralph (independent)
- Peter Warne (ASX appointee)

Further details of the directors are enclosed with this submission.

SEGC Board renewal

SEGC conducts Board renewal processes in line with the ASX Corporate Governance Principles and Recommendations. The most recent Board renewal process was delayed as a consequence of the introduction of competition for market services and uncertainty as to whether this would result in market licensees other than ASX seeking to become members of SEGC. To date, this has not occurred, and all other licensed markets have elected to establish Division 3 compensation arrangements rather than join SEGC.

During this process, candidates from a range of backgrounds were considered for Board positions. After considering all candidates, the Board was delighted that Nancy Milne and Lynn Ralph accepted invitations to join.

The Board considers it critical that directors have the competencies, skills and experience necessary to discharge its functions – in particular, an understanding of the Board's role as a trustee with defined statutory functions, financial experience and acumen, including an appreciation of investment, risk and insurance matters, and a strong understanding of the contemporary institutional and retail stockbroking industry.

SEGC Directors

Susan Doyle, BA, Non-Executive Director. Director since January 2007.

Member of the Future Fund Board of Guardians. Chair of State Library of NSW Audit Committee. Director of Lawcover Pty Limited and Lawcover Insurance Pty Limited. Director of Barbara May Foundation.

Former Chairman of Commonwealth Superannuation Corporation. Former Director of Aircruising Australia Ltd. Former Director of South Australian Water Corporation.

Ian McGaw, Non-Executive Director. Director since July 2010.

Chairman of ASX Clear Pty Limited, ASX Settlement Corporation Limited and ASX Settlement Pty Limited. Director of ASX Clear (Futures) Pty Limited, ASX Clearing Corporation Limited and Austraclear Limited.

Former Group Managing Director at the London Clearing House (now known as LCH Clearnet Group).

Nancy Milne, LLB, OAM Non-Executive Director. Director since October 2011.

Consultant to Clayton Utz. Director of Australand Holdings Limited (and chair of the Risk and Compliance Committee). Director of Munich Reinsurance Australasia Limited and Munich Holdings Australia Pty. Limited (and a member of the Risk and Compliance Committee, the Audit Committee and the Remuneration Committee). Director of Commonwealth Managed Investments Limited, responsible entity for the Commonwealth Property Office Fund and the CFS Retail Property Trust and other unlisted trusts (and a member of the Audit Committee). Director of The Colonial Mutual Life Assurance Society Limited (and a member of the Audit and Risk Committee). Director of Commonwealth Insurance Limited (and a member of the Audit and Risk Committee).

Chair of Montessori Children's Foundation. Director of Australian International Disputes Centre.

Lynn Ralph, MBA, BA Non-Executive Director. Director since December 2011.

Chairman of BT Funds Management Ltd group of companies within BT Financial Services Group, Westpac. Commissioner of the Private Health Insurance Administration Council. A Director of Bangarra Dance Theatre Australia Ltd., Sydney Swans Ltd., and Sydney Institute Ltd. Principal and Managing Director of Cameron Ralph Pty Ltd.

Former Chief Executive Officer, Investment and Financial Services Association. Former Deputy Chair of Australian Securities Commission.

Peter Warne, BA, Non-Executive Director. Director since October 2006.

Appointed Director of ASX in July 2006. Prior to this he was a Director of SFE Corporation Limited from 2000.

Director of ASX Clear Pty Limited, ASX Clear (Futures) Pty Limited, ASX Clearing Corporation Limited, ASX Settlement Corporation Limited, Austraclear Limited and ASX Settlement Pty Limited. Member of the ASX Audit and Risk Committee, the Nomination Committee and the Remuneration Committee.

Chairman of Australian Leisure and Entertainment Property Management Limited. Deputy Chairman of Capital Markets CRC Limited. Director of Macquarie Group Limited, Macquarie Bank Limited, Next Financial Limited (owned by Wilson HTM Investment Group Limited), Securities Industry Research Centre of Asia Pacific (SIRCA) and Mosaic Risk Management Pty Limited. Deputy Chairman of WHK Group Limited. Chairman of St. Andrews Cathedral School Foundation. Member of the advisory board of the Australian Office of Financial Management. Former Member of the Compliance Committee of Wilson HTM.

Adjunct Professor University of Sydney Business School. Member of the Macquarie University Faculty of Business and Economics Advisory Board. Patron of the Macquarie University Foundation.

Former director of Macquarie Capital Alliance group. Former Executive Vice-President of Bankers Trust Australia Limited.

22 November 2002

Ms Ruth Smith
Acting Manager
Market Integrity and Payments Unit
Financial Markets Division
The Treasury
Langton Crescent
CANBERRA ACT 2600

Dear Ruth

Compensation for loss in the financial services sector

Thank you for providing SEGC with the opportunity to make a preliminary submission in relation to the issues and options paper on compensation for loss in the financial services sector. SEGC's preliminary submission is enclosed.

I note that information about claims on SEGC is included in the issues and options paper. Earlier this week Jenni Mack of the Centre for Financial Services Consumer Policy asked me to provide her with further information about the number of claims on SEGC in the last five years and the outcome of those claims. I informed her that in the last five financial years there were 178 claims on SEGC. Of those claims 7 were allowed, 129 were settled by SEGC, 30 were disallowed, 4 were time-barred and 8 were withdrawn.

If you have any queries in relation to SEGC's preliminary submission please do not hesitate to contact me.

Yours sincerely

Sally Palmer
Manager, Legal Counsel
and Company Secretary

Enclosure

SECURITIES EXCHANGES GUARANTEE CORPORATION LIMITED (SEGC)

PRELIMINARY SUBMISSION

ON THE

ISSUES AND OPTIONS PAPER ON

COMPENSATION FOR LOSS IN THE FINANCIAL SERVICES SECTOR

NOVEMBER 2002

Securities Exchanges Guarantee Corporation Limited
Level 9, 20 Bridge Street
Sydney NSW 2002

Executive Summary

SEGC is pleased to have the opportunity to make a preliminary submission in relation to the issues and options paper on compensation for loss in the financial services sector (Treasury Paper).

SEGC considers that there is justification for requiring, through legislation, compensation arrangements in the financial services sector. These arrangements should include a requirement that financial services licensees, as a condition of their licence, have professional indemnity insurance.

There should also be some form of scheme to compensate investors who suffer loss. It is difficult to provide a detailed submission as to the requirements for a compensation scheme without an understanding as to the type of compensation arrangements which are proposed. SEGC makes some preliminary comments in relation to compensation schemes in this submission and will provide a detailed submission once it has an indication as to the arrangements proposed.

SEGC considers that claims on any compensation scheme should be subject to monetary caps.

As to the funding of a scheme, SEGC opposes a proposal that funds currently held in the National Guarantee Fund (NGF) be used as initial funding for a broad scheme. This would not be consistent with the purposes for which the NGF is held on trust. SEGC considers that a broad scheme should be funded by the financial services licensees whose conduct is covered by the scheme. This can be achieved if the scheme is funded by interest on trust accounts and levies on financial services licensees. If there is an initial levy to establish a broad scheme, and the scheme is to cover liabilities presently covered by market compensation funds, it may be appropriate for the levy payable by market participants to be paid from the relevant market compensation fund.

Finally, SEGC supports the use of excess funds in a compensation scheme for financial industry development funding as this has benefits for the public, the financial industry and the clients of that industry.

These and other matters are discussed in more detail below.

Justification for requiring compensation arrangements

SEGC considers that there is justification for requiring, through legislation, compensation arrangements in the financial services sector. The reasons for this are as follows:

- Consumers may not be in a position to protect their interests when dealing with financial services licensees due to a lack of information or experience in relation to financial products and the financial services industry. As noted in the Treasury Paper, consumers may not make major investment decisions frequently, and hence may have little experience in relation to those decisions.

- Consumers may not be able to seek compensation from financial service licensees through legal action due to a lack of resources, or a lack of information and experience. Further, if a licensee is insolvent legal remedies may be of no use, particularly if there are insufficient funds to meet claims and/or trust funds have been misappropriated.

- Loss resulting from the insolvency and/or improper conduct of a financial services licensee may have a significant financial effect on the clients of that licensee. As noted in the Treasury Paper,

clients may have all their investments managed by one licensee. Hence, the loss arising from insolvency and/or improper conduct of that licensee may result in financial ruin for the clients.

- If there are no compensation arrangements in place consumers may lack confidence in the financial services industry and be unwilling to use the services provided by that industry. This would be detrimental to the financial services industry. It may also be detrimental to the economy as a whole if consumers are unwilling to participate in the securities markets and other forms of investment.

The Treasury Paper refers to concerns that consumers and financial services licensees will take less care because losses will be covered by compensation arrangements (referred to as "moral hazard"). In the case of clients, concerns about moral hazard can be addressed through the capping of claims. This is discussed in more detail below. In the case of financial services licensees, provided that the responsibility for making compensation arrangements is on the licensees (whose conduct cause the loss) any scope for moral hazard will be minimized. Further, it is reasonable to assume that most financial services licensees wish to remain solvent so that they can remain in business. Hence, compensation arrangements which apply when a licensee is insolvent are unlikely to result in a moral hazard.

Finally, requiring some form of compensation arrangements in the financial services sector is consistent with international practice. Each of the USA, Canada, the UK, the EU, Ireland, Singapore and Hong Kong have some form of investor compensation arrangements.

Professional indemnity insurance for financial services licensees

SEGC considers that financial services licensees should be required, as a condition of their licence, to have professional indemnity insurance.

Professional indemnity insurance provides funds to meet claims by consumers against financial service licensees. These funds can also be recovered by the operator of a compensation scheme (provided that there is a right of subrogation when a claim is paid). This reduces the cost of the scheme and the likelihood that the losses relating to one financial services licensee will be funded out of contributions from other licensees (cross-subsidization).

Further, the requirement that financial services licensees have professional indemnity insurance places responsibility for compensation directly on the licensee. As noted in the Treasury Paper this should be an incentive for the licensee to act properly, provided that the premium accurately reflects the risk involved in covering that licensee.

SEGC considers that professional indemnity insurance held by financial services licensees should cover negligence, breach of contract and statute and fraudulent acts by officers, employees or authorised representatives. The cover should extend to determinations of any external dispute resolution scheme of which the licensee is a member. More extensive cover, such as run-off cover and cover for legal defence costs may also be desirable as it would provide a greater level of protection for clients of financial services licensees. However, the cost and availability of this type of insurance would need to be taken into account.

The fact that certain licensees are regulated by APRA, have high financial requirements or high market capitalisation, or have the requisite connection with such a body may be relevant to whether the licensee is required to have professional indemnity insurance. It may be appropriate for such licensees to self-insure or make other compensation arrangements approved by ASIC in the place of

professional indemnity insurance, provided that these arrangements ensure that funds are available to meet claims by clients.

The Treasury Paper asks whether membership of a market compensation scheme would, to some extent, satisfy the obligation on a financial services licensee to have compensation arrangements. As noted above, one of the benefits of requiring financial services licensees to have professional indemnity insurance is that it provides a source of funds which can be recovered by the operator of a compensation scheme pursuant to a right of subrogation, thereby reducing the cost of the scheme and the likelihood of cross-subsidization. It also encourages financial services licensees to act properly and take responsibility for their own conduct. For these reasons, SEGC does not consider that membership of a compensation scheme should satisfy, to some extent, the obligation on a financial services licensee to have compensation arrangements.

SEGC agrees with the preliminary view of Treasury that surety bonds (such as the $20,000 bond which securities dealers and advisers are required to lodge with ASIC under the existing system) do not provide adequate protection. SEGC considers that professional indemnity insurance is a more effective means of ensuring that funds are available to meet claims against licensees.

Compensation schemes

SEGC considers that there are strong arguments in support of having arrangements to compensate investors who suffer loss. These include the following:

- A compensation scheme can operate in conjunction with the requirement that financial services licensees have professional indemnity insurance.

- A scheme operator will be better placed than consumers to investigate claims, acquire documents and information and seek recovery from the licensee. Hence, the scheme will provide protection for clients who do not have the resources or expertise to pursue claims directly. Once a claim has been paid the scheme operator can then pursue the licensee or its insurer to recover the compensation paid out (provided that it is subrogated to the claimant's rights).

- Making a claim on a compensation scheme is a relatively simple process for a consumer and if the claim is made out they will receive compensation fairly quickly, thereby minimizing any financial hardship resulting from their loss.

- Depending on the extent of the insurance cover which financial services licensees are required to have in place a compensation fund may cover matters which are not covered by the licensee's insurance. This is an important protection for the consumer, particularly in circumstances where the licensee is insolvent.

It is difficult to provide a detailed submission as to the requirements for a compensation scheme without an understanding as to the type of compensation arrangements which are proposed. However, SEGC has the following preliminary comments.

Responsibility for making compensation arrangements should ultimately rest with the financial services licensee (whose conduct causes the loss). Hence, any compensation scheme should ensure that responsibility for compensation is placed directly on licensees.

If significant reforms to the current compensation arrangements are proposed, for example by way of the introduction of a broad statutory scheme, it will be necessary to proceed with caution. Any plan to reduce the level of protection currently available to clients under a compensation scheme should be assessed carefully to ensure that those clients will not be disadvantaged. Further, although responsibility for making compensation arrangements should rest with the financial services licensee there are benefits in representatives of market operators having some involvement in the scheme (or that aspect of it which relates to market participants) as they are aware of and have some influence over the activities of participants which may give rise to claims.

While a broad statutory scheme has benefits in theory there may be practical difficulties in implementing a scheme which covers the conduct of a broad range of financial services licensees. Hence, there would need to be detailed consideration and consultation as to how the scheme is to be implemented including consideration of how the scheme will provide compensation which is suitable for clients of all sectors of the financial services industry. It would also be important to take steps to ensure that the scheme does not result in some sectors of the financial services industry cross-subsidizing other sectors. Finally, if significant reforms are proposed it may be necessary to introduce those reforms in stages.

Alternatively, if the current market based compensation schemes are to be retained in some form then a number of issues in relation to those schemes would need to be addressed. These include:

- the overlap between compensation schemes which may give rise to forum shopping; and

- the lack of uniformity between the different schemes which means that the type and amount of compensation available may depend upon the market of which the financial services licensee who caused the loss is a participant.

SEGC looks forward to providing a detailed submission in relation to the requirements for a compensation scheme, including the matters referred to above, once it has an indication as to the type of compensation arrangements which are proposed.

Eligible claimants

SEGC considers that there should be a limit on the claims which can be made on any compensation scheme. This can be achieved by restricting access to the scheme to retail clients or by imposing a cap on claims, or both. As discussed below SEGC supports the capping of claims.

Operation and governance of a compensation scheme

SEGC agrees with the comment in the Treasury Paper that if a broad scheme is adopted, SEGC, as a wholly owned subsidiary of the ASX, would not be an appropriate body to operate the scheme. If SEGC's structure was modified so that it became independent of ASX it may be an appropriate body to operate the scheme. However, any such proposal would require further consideration and consultation once there is a better indication as to the nature of any broad scheme proposed.

As SEGC has submitted previously, there are difficulties with the proposal in the CASAC Paper[1] that an existing ASIC approved dispute resolution industry body be appointed as a scheme

[1] Consultation Paper – Retail Client Compensation in Financial Markets, Companies and Securities and Advisory Committee, September 2001

operator[2]. SEGC considers that it would be preferable for a scheme operator to be an independent entity whose powers, functions and responsibilities are set out in legislation.

Initial funding of a compensation scheme

As submitted previously, SEGC opposes any proposal, such as that in the CASAC Paper, that transitional arrangements deal with the transfer of funds currently held by the NGF to a new broad scheme[3]. The reasons for this are as follows:

1. There may be legal impediments preventing the implementation of the proposal for constitutional reasons relating to the acquisition of property on just terms. It may not be possible, for example, to appropriate funds from the NGF unless adequate compensation is paid for that appropriation. If this is the case, there seems little point in appropriating cash from the NGF if an equivalent amount of cash must then be paid as compensation for that appropriation.

2. There are important equity, cross subsidization and fairness issues which the CASAC proposal does not address.

   There seems to be an assumption underlying the suggestion that the NGF should fund a statutory scheme during a transitional period that the NGF is a public fund that can be used for a variety of purposes. This assumption is misplaced.

   SEGC holds the NGF as trustee pursuant to a statutory trust. The NGF has a range of "beneficiaries" who are "entitled" to claim on the Fund in a range of circumstances. Those beneficiaries and the circumstances in which they are "entitled" to the NGF's funds are not necessarily the same as the beneficiaries of a broad statutory scheme. CASAC's proposal could therefore potentially result in a payment being made from the NGF to persons who are not and could never be beneficiaries of the NGF. This would be inequitable.

   A payment out of the NGF to a new scheme operator is distinguishable from the FSR proposal to split the NGF. The latter proposal will result in a payment from the NGF to a body corporate in return for that body corporate assuming the "liabilities" currently undertaken by the NGF. The range of beneficiaries entitled to claim on these monies, before and after the split, would remain the same.

3. The proposal is inconsistent with the proposition, which is supported in both the CASAC Paper and the Treasury Paper, that the scheme should be industry funded. That is, the scheme should be funded by the financial services licensees whose conduct is covered by the scheme.

   As noted above, a broad statutory scheme will potentially apply to a wide variety of claims and licensees which are not presently covered by the NGF. Hence, the "industry" which will benefit as a result of the scheme is not the same industry that currently benefits from the NGF.

4. No adequate criteria was identified by CASAC to justify why the NGF should fund the scheme or how much funding would be required.

   The only criteria mentioned in the CASAC Paper is that a substantial transfer could benefit intermediaries (ie financial services licensees). In SEGC's submission that is an irrelevant

[2] Letter from SEGC to CASAC dated 19 October 2001 (CASAC Submission 2001), pages 6-7
[3] CASAC Submission 2001, page 4

consideration. It does not justify why the NGF (as opposed to licensees) should fund the scheme. Government funding of the scheme would also benefit licensees but that is not a reason why government funding should occur. SEGC considers that those who benefit from the scheme should fund it. On that basis there are no grounds to justify NGF funding the scheme. If the scheme is to be funded by industry then there should be no reason why the transition period should be treated any differently in this regard.

5. SEGC is not convinced that any payment from the NGF is necessary to ensure adequate funding of the scheme.

   As discussed below a broad statutory scheme should be funded from other sources such as interest on trust accounts and levies on financial services licensees.

In the event that market licensees no longer had to make compensation arrangements, the funds in the NGF should be used in a manner consistent with the purposes for which those funds are held by SEGC. That is:

- Providing compensation to investors in respect of their relationship with ASX Participating Organisations (the investor protection function).

- Supporting the integrity of ASX's markets and clearing and settlement systems and providing financial backing for ASX related clearing houses (the clearing guarantee function).

- To the extent of any "excess", providing funds for projects relating to the development of the financial industry (the FIDA function).

As noted above, in the event that the NGF is split, an appropriate amount should be paid out of the NGF to the body corporate providing a clearing and settlement guarantee, in return for that body corporate assuming the "liabilities" currently undertaken by the NGF. This use of funds is consistent with the clearing guarantee function.

Further, any projects for the development of the financial industry which have been approved by the Minister at the time when market operators are no longer required to make compensation arrangements should be funded out of the excess of the NGF. It is also appropriate for some funds to be set aside for future FIDA projects. This use of funds is consistent with the FIDA function.

Finally, if a broad statutory scheme is established which assumes some of the "liabilities" currently undertaken by the NGF it may be appropriate for SEGC to make an initial payment to that scheme in lieu of any initial levies which would otherwise have been payable by ASX Participating Organisations. This use of funds would be consistent with the investor protection function. It would also be consistent with the proposition that a broad scheme should be funded by the financial services licensees whose conduct is covered by the scheme. A similar contribution could be made by other market compensation schemes in lieu of any initial levies payable by participants of those markets.

Ongoing funding of a compensation scheme

If a broad scheme is adopted it should be funded by the financial services licensees whose conduct is covered by the scheme. This can be achieved if the scheme is funded by interest on trust funds and levies on financial services licensees.

The payment of trust account interest to a compensation scheme has direct benefits for clients as it provides a source of funds so that the assets of the scheme can be increased. This contributes to the ongoing soundness of the scheme and allows the scheme to meet current and future claims. Clients also benefit indirectly from the payment of trust account interest to a compensation scheme if there are excess funds in the scheme which can be used for financial industry development funding. As discussed below, financial industry development funding has benefits for the public, the financial industry and the clients of that industry.

If interest on trust accounts is not paid to a compensation scheme then it is likely that this interest will be retained by the financial services licensees[4]. There is no reason why licensees should have this windfall gain which has no benefits to clients or the financial industry. If, instead, interest on trust accounts is paid to a compensation scheme then that interest would be used for the benefit of the clients whose funds are held on trust by funding a scheme for the protection of those clients.

The scheme operator should have the power to impose levies on the members of the scheme, and to take out insurance or to borrow funds as it considers appropriate. This gives the scheme operator some flexibility in funding the scheme, depending upon the amount of funds received from trust account interest and the claims experience. In imposing levies the scheme operator should have a discretion as to whether to levy transactions or licensees or a certain class of transactions or licensees, depending upon the circumstances giving rise to the need for a levy.

As noted above, if there is an initial levy to establish a broad scheme, and if the scheme is to cover liabilities presently covered by market compensation funds, it may be appropriate for the levy payable by market participants to be paid from the relevant market compensation fund. This would be a one off payment in consideration for the scheme taking over liabilities from the market compensation funds.

If the current compensation arrangements are retained, SEGC submits that NGF should continue to receive interest on the trust accounts held by Participating Organisations of ASX. As discussed above, the payment of trust account interest to a compensation scheme has direct and indirect benefits for clients and benefits for the financial industry as a whole. There is no reason why this interest should be retained by Participating Organisations of ASX.

SEGC will address these matters in more detail once it has an indication as to the type of compensation arrangements proposed.

Capping of claims

SEGC strongly supports the capping of claims on compensation schemes. If a broad statutory scheme is adopted SEGC submits that claims on that scheme should be capped. Alternatively, if the present market compensation schemes are retained SEGC submits that claims on the NGF should be capped (other schemes already being subject to caps).

Capping of claims generally

With any compensation scheme, it is necessary to consider the extent of claims coverage. While a scheme with no restrictions on claims would provide complete protection to clients and promote confidence in the financial services industry, ultimately such a scheme may act to clients' detriment.

[4] Under Corporations Regulation 7.8.02(7) a financial services licensee may retain interest on trust accounts provided that this is disclosed to clients.

This is because such an arrangement would create a moral hazard and allow clients to take unacceptable risks in the knowledge that the scheme would be available to protect an individual from all loss. The costs of such a scheme may be excessive and would ultimately be passed on to clients.

Claims on a scheme can be limited by either specifying eligibility criteria limiting the types of complainants that can access the scheme or by monetary caps on claims, or both. SEGC supports the use of monetary caps on claims as this is a simple and effective way of limiting claims on a scheme. As discussed above there may be further benefits in also restricting access to the scheme to retail clients.

SEGC's reasons for supporting a monetary cap on claims generally are as follows.

1. *Structural soundness*

   If there is no limit on claims the liability of a scheme is potentially unlimited. It is therefore theoretically possible for a single claim or a series of large claims to wipe out all funds held by the scheme.

   This is an unsatisfactory situation as it undermines the ongoing structural soundness of the scheme.

2. *Moral hazard*

   As noted above, if there are no limits on the amount that can be claimed this may encourage clients to take unacceptable risks in the knowledge that the scheme is available to protect them.

3. *Consistency with external dispute resolution schemes*

   ASIC's policy on external dispute resolution schemes provides for monetary limits on claims. For example, the Financial Industry Complaints Service (FICS) has a limit of $100,000 on complaints involving securities. If a compensation scheme is to some way operate in conjunction with external dispute resolution schemes it is appropriate that the scheme also has monetary limits on claims.

4. *International comparison*

   All international compensation schemes in the financial services industry of which SEGC is aware impose limits on the scope of compensation, either by the capping of claims or eligibility criteria restricting the types of claimants, or both.

   For example, monetary caps on claims are imposed by investor compensation schemes in the USA, Canada, Hong Kong, Singapore, the UK and Ireland. Note that schemes in Hong Kong, Singapore, the UK and Ireland also have eligibility criteria for claimants.

Capping of claims on the NGF

If the present market based compensation schemes are retained, SEGC submits that claims on the NGF should be capped.

At present, with the exception of claims for property entrusted to a broker that subsequently becomes insolvent, there is no cap on claims on the NGF. Further, the NGF has no eligibility criteria restricting the category of claimants to, for example, retail clients.

The reasons for capping claims generally which are set out above apply to the NGF. Further, the following reasons for capping claims relate specifically to the NGF.

1. *Comparison to other domestic compensation arrangements*

   In contrast to the open ended liability of the NGF other domestic compensation arrangements (many of which overlap with NGF coverage) recognise the importance of capping.

   Claims under the current fidelity fund arrangements of the old Part 7.9 claims on fidelity funds are capped at $500,000 per member firm. Further, as noted above, external dispute resolution schemes have a monetary claims limit prescribing the maximum monetary amount that may be claimed, with FICS having a limit of $100,000 in the case of complaints involving securities.

   It is incongruous that schemes potentially covering the same loss impose different compensation limits. If, for example, a person suffers pecuniary loss as a result of a broker who is a participant of both ASX and NSX fraudulently transferring their securities, that person has a number of options available to them to obtain compensation. They could make a claim on FICS, they could make a claim on the NSX fidelity fund or they could make a claim on the NGF.

   Of the three sources of compensation, only the NGF has an unlimited exposure. Why should the NGF have unlimited liability in this instance but the NSX fidelity fund or FICS have only limited liability? The existence of unlimited liability may make it more attractive to a claimant to pursue a claim on the NGF rather than any of the other compensation schemes. There is no compelling reason why only the NGF should be "singled" out in this way. This is particularly so given that if the NGF exercised its right of subrogation and pursued claims on the fidelity fund or FICS it would be bound by those limits. In this way, the Fund would be diminished (by paying out the claim) with no satisfactory means for full replenishment.

   The imposition of caps on the NGF would, apart from the other benefits identified in this submission, go some way towards discouraging claimants from engaging in possible forum shopping amongst the various compensation arrangements.

2. *No reduction in investor protection*

   As discussed below, SEGC considers that a cap of $500,000 may be appropriate. A cap of this amount would not result in any substantial reduction in investor protection by the NGF. The NGF's claims history reveals that the vast majority of claims that have been paid by the NGF would have fallen within the proposed cap.

   In the period 1994-2002 no claim would have exceeded the proposed cap. The largest amount paid to a claimant in this period was only $127,524.

   Since its inception, the NGF has only paid compensation in excess of $500,000 on four occasions:

Amount of claim **$**	**Claims division**
561,250	Division 6 (selling client claim)
583,714	Division 6 (selling client claim)
603,686	Division 8 (property entrusted)
642,850	Division 6 (selling client claim)

The following observations can be made about this claims history:

- All of the claims related to an insolvent broker.

- One of the four claims was made under Division 8 (property entrusted/insolvency) and would therefore already be subject to the cap of 14% of the minimum amount.

- If a cap of $500,000 applied then in the remaining three claims, the claimants would have been compensated for 89%, 86% and 78% of their loss respectively.

- Only one of the four claims (that for $603,686) was made by an individual retail client. The other three claims were made by institutional investors. If, therefore, in addition to imposing a cap on claims, eligibility criteria excluded non retail clients from making claims, these claims would all fall outside the scope of coverage.

A cap of $500,000 would not therefore reduce the scope of investor protection in any significant way. Note that the ASX 2000 Share Ownership Study shows that the average share portfolio of retail investors is $28,000 and the average dollar value of share parcels traded is $5,500. In the vast majority of cases, the cap would simply have no adverse impact on claimants.

Appropriate form of capping

SEGC considers that a cap of $500,000 may be appropriate for claims on the NGF. There are two main reasons for selecting this amount:

1. *This amount can be linked to an objective standard - the sophisticated investor test under the Corporations Act.*

   The rationale underpinning the sophisticated investor test in the context of the disclosure rules, namely that certain investors are seen to be financially sophisticated and are therefore able to protect their own investment interests without regulatory interference, would appear to be equally applicable in the context of selecting a ceiling on the amount of compensation payable by the NGF.

   The Board of SEGC recognises that any ceiling on claims will need to be reviewed from time to time and, if necessary, increased. By linking the capped amount to the sophisticated investor test, it would follow that any increase in that test would automatically result in an increase to the capped amount. An alternative may be to leave it to the discretion of the Board of SEGC to review (and increase) the appropriateness of the capped amount in much the same way as it assesses the adequacy of the "minimum amount".

2. *A figure of $500,000 would mean that the vast majority of claims made on the NGF to date would continue to fall within it.*

   As discussed above, most claims on the NGF to date have been for less than $500,000.

Further, a cap of $500,000 is generous in comparison with most other compensation scheme as demonstrated below:

Scheme	**Level of cap**	**Approximate A$ equivalent**
USA	$500,000 per customer except that claims for cash are limited to $100,000 per customer.	$920,000 (cash claims of $184,000)
Canada	up to $1m per a customer's general account.	$1.17m
UK	100% of the first £30,000 and 90% of the next £20,000 up to a maximum payment of £48,000.	$138,000 maximum payment
European Union	The lesser of €20,000 or 90% of the net loss, whichever is the lesser.	$36,000
Hong Kong	A per claimant limit of $150,000.	$35,000
Singapore	$2m in respect of each member and $50,000 for each claimant.	$2.06m (per member) $51,000 (per claimant)
FICS	$100,000	$100,000
Old Part 7.9	$500,000 per member	$500,000 per member

The matters set out above also support the view that a cap of $500,000 may be appropriate for a broad statutory scheme.

Financial Industry Development Funding

SEGC considers that if a broad scheme is adopted excess funds from that scheme should be available for financial industry development purposes.

As discussed above, one function of the NGF is, to the extent of any "excess", to provide funds for projects relating to the development of the financial industry that are conducted for the public benefit (referred to as FIDA funding). Previously, funds were provided for the development of the securities industry (referred to as SIDA funding).

SIDA funding has been used for a variety of projects relating to the development of the securities industry in Australia. For example, SIDA funding has been used:

- To provide infrastructure support for the Securities Industry Research Centre of Asia Pacific.
- To develop a securities teaching laboratory at the Australian Graduate School of Management.
- To assist the Securities Institute of Australia.

- To fund a variety of investor education projects.

FIDA funding can be used for projects for the development of the financial industry which are for the public benefit. These include:

- Public education activities.

- Research into future product or service needs.

- Research and consulting services intended to improve the international performance of Australian financial markets.

- Improvement of Australia's role as a financial centre[5]

SIDA funding has been extremely beneficial to the securities industry. Financial industry development funding will be equally beneficial to the financial industry in the future. This results in benefits for the public, and in particular, for consumers who use the services provided by the financial industry. Hence, the use of excess funds in a compensation scheme for financial industry development funding is in the best interests of the public, the financial industry and the clients of that industry.

[5] Note to Corporations Regulation 7.5.88.

SECURITIES EXCHANGES GUARANTEE CORPORATION LIMITED (SEGC)

SUBMISSION ON THE POSITION PAPER ON

COMPENSATION FOR LOSS IN THE FINANCIAL SERVICES SECTOR

JANUARY 2004

Securities Exchanges Guarantee Corporation Limited
Level 9, 20 Bridge Street
Sydney NSW 2000

Executive Summary

SEGC is pleased to have the opportunity to make a submission in relation to the position paper on compensation for loss in the financial services sector.

SEGC agrees with the proposal that financial services licensees be required to have professional indemnity insurance. Alternatives to professional indemnity insurance may also be appropriate if it can be demonstrated that they provide comparable consumer protection to professional indemnity insurance.

In relation to market compensation arrangements, SEGC strongly supports limiting payments from the National Guarantee Fund (NGF or the Fund) by imposing monetary caps and submits that regulations should impose a cap of $500,000 on the amount of compensation to which a person is entitled in respect of a claim on the NGF. SEGC supports in principle the capping of levies to fund the NGF but only if payments from the NGF are also capped, as SEGC should not have a limitation on its ability to raise funds while its liability for claims is unlimited. SEGC considers that amendments are required to address the overlap in compensation provided by different market compensation arrangements and the lack of uniformity between those arrangements.

These and other matters are discussed in more detail below.

Professional indemnity insurance for financial services licensees

SEGC agrees with the proposal to amend section 912B to require financial services licensees to have compensation coverage, such as professional indemnity insurance, for:

- acts, errors or omissions for which the licensee is legally liable and such conduct of its representatives for which it is responsible (but excluding civil and criminal penalties imposed on the licensee);
- in the course of:
    - dealing on behalf of;
    - advising; or
    - providing custodial or depository services;

  to retail clients on financial products.

However, it may not be appropriate to limit the insurance coverage to conduct within the licensee's licence, given that conduct which causes loss to a client may well be in breach of the licence.

SEGC does not consider that any particular statutory obligation should be exempt from insurance coverage on the basis that coverage may encourage non-compliance with the obligation. Insurance should be in place to provide funds to meet claims by clients where the loss results from a breach of a statutory obligation. Further, it is not clear that insurance coverage in relation to statutory obligations would encourage non-compliance. Financial services licensees are required to comply with financial services laws, which are defined to include any Australian legislation that covers conduct relating to the provision of financial services, and ASIC may suspend a licensee (after offering a hearing) for failure to comply with this obligation[1]. This, and other legal consequences of a failure to comply with a statutory obligation, should deter non-compliance regardless of the insurance coverage in place.

[1] Corporations Act, sections 912A and 915C

Alternatives to professional indemnity insurance may be appropriate if it can be demonstrated that they provide comparable consumer protection to professional indemnity insurance. Any such arrangement should ensure that there will be adequate funds available to meet claims by clients. Similarly, if bodies with high capitalisation can gain an exemption from the requirement to have insurance, the test to qualify for that exemption should ensure that those bodies have adequate funds to meet claims by clients, even in circumstances of financial stress.

The position paper states that the requirement that licensees have professional indemnity insurance (or similar arrangements) and the requirement that markets have compensation arrangements under Part 7.5 of the Corporations Act should complement each other as the administrator of a Part 7.5 arrangement is subrogated to the rights of the claimant against the financial services licensee which is backed by insurance. Consistent with this, it will be important to ensure that insurance will cover all losses which may give rise to claims on compensation arrangements. Further, in considering whether alternatives to professional indemnity insurance are adequate and whether some bodies should be exempt from the requirement to have insurance the availability of funds to meet subrogated claims should be a relevant factor.

Market compensation arrangements

Limiting payments from the NGF

SEGC strongly supports limiting payments from the NGF by imposing monetary caps. At present, there are no caps on payments from the NGF other than a cap of $11.2 million in relation to claims for property entrusted to a dealer that becomes insolvent. Hence, the NGF is exposed to potentially unlimited liability for claims.

As discussed in SEGC's submission of November 2002 a cap on payments would:

- ensure the structural soundness of the Fund and facilitate the actuarial calculation of the amount required by the Fund;
- reduce the moral hazard whereby clients take unacceptable risks in the knowledge that there are no limits on the compensation available;
- be consistent with external dispute resolution schemes which may impose monetary limits on claims and reduce the possibility of forum shopping;
- be consistent with international compensation schemes in the financial services industry which, as far as SEGC is aware, all impose monetary limits on claims.

Further, a cap on payments would be consistent with compensation arrangements under Division 3 of Part 7.5 of the Corporations Act to the extent that the rules for those arrangements may impose an upper limit on the amount of compensation to which a person is entitled in respect of a claim[2].

SEGC considers that a cap of $500,000 on payments from the NGF would be appropriate. A cap of this amount would not result in any substantial reduction in investor protection by the NGF. As discussed in SEGC's submission of November 2002 a cap of $500,000 would have limited payments from the NGF on only 4 occasions since the Fund's inception in 1987. Further, a cap of $500,000 is generous in comparison with most other international and domestic compensation schemes.

The submissions made in response to the Issues and Options Paper on Compensation for Loss in the Financial Services Sector indicate that there is widespread support for limiting payments from a compensation scheme either by imposing a monetary cap on payments from the scheme or by

[2] Corporations Act, section 885E(3)

restricting access to the scheme to retail clients, or both. While these submissions do not relate specifically to the NGF they support the general view that there should be a limit on claims on a compensation scheme.

The Corporations Act provides that regulations may impose an upper limit on the amount of compensation to which a person is entitled in respect of a claim in particular circumstances[3]. For the reasons set out above, SEGC submits that regulations should impose an upper limit of $500,000 on the amount of compensation to which a person is entitled in connection with a claim on the NGF.

The capping of claims may diminish NGF protection in relation to clients of an intermediary (e.g. financial planner) in circumstances where the intermediary, and not the original client, is the client of a broker (referral business). The intermediary could make a claim on the NGF, thereby giving the clients indirect protection, but only up to the amount of the cap. SEGC suggests that in these circumstances the intermediary should be required to disclose to clients that they have no direct NGF protection and that any claim by the intermediary is subject to a cap. Note that if it was proposed to allow larger payments from the NGF in cases involving referral business a special cap should be imposed on the total amount that could be paid in relation to one intermediary.

Capping levies on participants to fund the NGF

The position paper seeks submissions as to whether a limitation on SEGC's power to levy participants to fund the NGF is appropriate to assist ADIs to meet APRA requirements.

SEGC supports in principle the capping of levies on participants. However, it submits that levies should not be capped while payments from the NGF remain uncapped[4]. As discussed above, at present there is no limit on payments from the NGF (other than for claims for property entrusted to an insolvent broker) and hence the NGF is exposed to potentially unlimited liability for claims. It is therefore theoretically possible for a single claim or a series of large claims to wipe out all funds held by the scheme. This is an unsatisfactory situation as it undermines the ongoing structural soundness of the NGF. This problem would be compounded if levies on participants were capped as this would result in a situation where SEGC is exposed to unlimited liability for claims while its ability to raise funds is limited.

Assuming that claims on the NGF are capped, it is then necessary to consider what cap on levies would be appropriate. The position paper suggests that one possible cap would be the value of each participating organisation's transactions over the previous year as a percentage of the total value of transactions covered by the NGF, multiplied by the number of dollars the NGF is below its minimum. However, this type of cap may give rise to the following difficulties in practice:

- Where one or more participants have become insolvent they will not be able to meet any levy by SEGC. Further, if participants have resigned since the previous year they will not be obliged to pay a levy. Hence, a levy based on a participant's proportion of the total transactions in the previous year may not be adequate to restore the NGF to the minimum amount. This is not consistent with the original intention of the levy power, which was to allow SEGC to maintain the minimum amount in the Fund[5].
- It is not clear how the cap would be applied to new participants (who were not participants in the previous year) or to participants who merge. Further, the total value of a participant's

[3] Corporations Act, section 888C(3)
[4] Note that it was ASX rather than SEGC that requested a limitation on levies in its initial submission (referred to in paragraph 312 of the position paper).
[5] Explanatory Memorandum, Australian Stock Exchange and National Guarantee Fund Bill 1987, paragraph 69

transactions in the previous year may not be an accurate indication of its market share in the year of the levy.

- It is not clear whether "transactions covered by the NGF" are intended to be limited to reportable transactions or to extend to other transactions to which NGF protection may be relevant. The value of transactions other than reportable transactions would be very difficult to determine. Further, if access to the NGF is limited to retail clients (as discussed in the position paper) then transactions covered by the NGF would be limited to transactions by retail clients. The value of these transactions for each participant would be difficult to determine.

In view of these difficulties, SEGC considers that it would be preferable that the cap be calculated simply by reference to the amount needed to restore the fund to the minimum amount in any one year. On this approach SEGC could impose a levy (or levies) in any year equal to the amount required to restore the Fund to the minimum amount. This would be consistent with the original intention of the levy power.

The levy would be calculated, as under the present arrangements, in a manner determined by SEGC. SEGC could, for example, impose a uniform levy on all (or a class of) participants. Alternatively, SEGC could calculate the levy (up to the amount of the cap) on some other equitable basis (e.g. a transaction/market share based approach). Note that if a levy was imposed to raise a significant amount it is more likely that SEGC would take the latter approach so as not to cause financial hardship to smaller participants.

It is important to ensure that any cap on levies will still allow SEGC to raise sufficient funds to meet claims and support the ongoing structural soundness of the Fund. Hence, it may be necessary for any amendments in relation to a cap on levies (or formula to determine a cap) to be subject to actuarial review once a decision is reached as to how payments from the NGF are to be limited.

Allocation of transactions to a particular market

The position paper states that the Government is willing to consider amendments to the provisions which attempt to allocate a particular transaction to a particular market (in the context of compensation arrangements) and in particular problems in relation to section 885D of the Corporations Act. As stated in SEGC's submission of November 2002, SEGC considers that amendments are required to address the overlap between compensation arrangements under Part 7.5 Division 3, which apply to markets other than ASX, and compensation arrangements under Part 7.5 Division 4 (i.e. the NGF), which apply to the ASX market.

Division 3 arrangements apply to losses which arise when a client gives money or other property, or authority over property, to a market participant "in connection with effecting a transaction, or proposed transaction, covered by provisions of the operating rules of the market relating to transactions effected through the market" and the client suffers loss as a result of defalcation or fraudulent misuse of that money or property (section 885C(1)). Section 885D provides that if a person suffers a loss which could be connected with 2 or more financial markets and it is not apparent from that person's instructions to the participant or the participant's usual business practice which of those markets the participant would use, then this is not a loss covered by the compensation arrangements under Division 3.

The NGF applies to losses in relation to contract completion, unauthorised transfer and property entrusted to an insolvent participant. However, unlike Division 3 arrangements, compensation for unauthorised transfer and entrusted property claims is not restricted to transactions in connection with the ASX market.

If a financial services licensee is a participant of both a non-ASX market and the ASX market there will be an overlap between the Division 3 compensation arrangements of the relevant non-ASX market and the NGF in 2 circumstances:

- where the conduct constitutes a fraudulent misuse/unauthorised transfer of securities; and

- where there has been a defalcation/fraudulent misuse of property entrusted to the participant, and the participant has subsequently become insolvent.

As a result of this overlap an unauthorised transfer or property entrusted claim could be made on the NGF, rather than the Division 3 compensation arrangement of the non-ASX market, even if the securities the subject of the claim are not ASX securities and the defalcation or fraudulent misuse occurred in relation to the participant's activities on the non-ASX market.

In order to address this problem, SEGC submits that the following limitations should be placed on NGF compensation arrangements:

- protection in relation to unauthorised transfers should apply only in relation to securities that are traded on the ASX market and should not apply if the transfer was effected on a market other than ASX; and
- protection in relation to property entrusted to a participant that becomes insolvent should apply only in relation to property that was entrusted to or received by the participant in connection with effecting a transaction, or proposed transaction, on the ASX market (or the CS facility to be operated by Australian Clearing House) or through a service offered by ASX.

Problems may also arise in relation to section 885D. Under this section, if a loss could be connected to 2 or more markets all of which have Division 3 compensation arrangements, but it is not clear which, the client would not be entitled to compensation. If the loss could be connected to 2 or more markets, one of which has Division 4 compensation arrangements (i.e. the ASX market), but it is not clear which, the client may be entitled to compensation from the NGF. These situations could arise where the loss relates to the misappropriation of money or property held by a participant for a client in circumstances where the client is trading on more than one market.

The uncertainty resulting from section 885D and the possible gap in compensation is not in the interest of clients of market participants. It would be preferable if the legislation provided that if the loss is connected to 2 or more markets, but it is not clear which, then the compensation arrangements of the relevant markets should be jointly liable to pay any compensation (provided that the compensation arrangements would otherwise cover the loss). In this circumstance the administrators of the compensation arrangements could jointly determine the claim.

A related problem which was also raised in SEGC's submission of November 2002 is the lack of uniformity in the claims provisions in Division 3 and Division 4. As noted above, Division 3 compensation arrangements are required to provide compensation in relation to defalcation or fraudulent misuse of money, property or authority over property by a participant. Division 4 compensation arrangements (i.e. the NGF) are required to provide compensation in relation to contract completion, unauthorised transfer and property entrusted to an insolvent participant. The differences in the protection provided by Division 3 and Division 4 arrangements are likely to result in client confusion and inequitable results. To avoid these problems SEGC submits that there should be uniform minimum standards for the protection offered by market compensation arrangements. Further, it would be preferable if there were more flexibility to modify the NGF

claims provisions to provide coverage for any new products traded on the ASX markets. If it is not considered appropriate to deal with these issues at present SEGC requests that they be reviewed in the future.

Information about compensation arrangements

SEGC considers that the best way to ensure that consumers do not have false expectations about compensation arrangements is to make information about those arrangements publicly available, as required under section 792I of the Corporations Act. Information about the NGF is made available to the public and/or clients of participants, by the following means:

- Information about the NGF is available on the websites of both ASX and SEGC. Further, the ASX website contains information as to what a client should do if they have a complaint against a broker, which includes information about the NGF.
- SEGC provides information, including a copy of an information booklet, free of charge to persons who contact SEGC or ASX seeking information about investor compensation.
- Under the SCH Business Rules a Sponsorship Agreement between a broker and a client must include a notification to the client that in the circumstances specified in the legislation the client may make a claim on the NGF for compensation.

SEGC submits that it would also be appropriate to require the Financial Services Guide, which financial services licensees are obliged to give to their retail clients[6], to include information on compensation arrangements. The Financial Services Guide is required to include information about the dispute resolution system that covers complaints by persons to whom the licensee provides financial services, and about how that system may be accessed[7]. There could be a similar requirement in relation to information on compensation arrangements. To avoid false expectations, the information provided should specify which services are covered by a compensation scheme and which services are not covered. Further, it would be useful if the information was provided to clients on a regular basis (e.g. yearly).

Other matters

The position paper refers to the case involving Thompson Brindal/Retireinvest relating to claims that clients lost around $17 million as a result of unauthorised trading and states that it is understood that a related company compensated clients and then sought reimbursement from the NGF. SEGC notes that the claims on the NGF were ultimately settled for an amount of $300,000. Some of the issues relating to these claims are discussed in Securities Exchanges Guarantee Corporation Ltd v Aird & Ors (2001) 161 FLR 420.

[6] Corporations Act, section 941A
[7] Corporation Act, section 942B

SECURITIES EXCHANGES GUARANTEE CORPORATION LIMITED (SEGC)

SUBMISSION ON THE CONSULTATION PAPER ON THE PROPOSED DIRECTION UNDER SECTION 891A OF THE CORPORATIONS ACT 2001

MARCH 2004

Securities Exchanges Guarantee Corporation Limited
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Sydney NSW 2000

Executive Summary

SEGC is pleased to have the opportunity to make a submission in relation to the consultation paper on the proposed direction under section 891A of the Corporations Act 2001.

SEGC agrees that there is justification for separating the functions of investor compensation and clearing and settlement support by way of a payment out of the NGF under section 891A. An updated report on the amount of assets which should be retained by the NGF to meet investor compensation claims will be provided prior to the proposed direction being made.

SEGC strongly supports limiting payments from the NGF by imposing monetary caps and considers that a cap of $500,000 per claim would be appropriate. SEGC agrees in principle with the proposed amendments in relation to levies, but considers that levies on participants should not be capped while claims on the NGF remain uncapped.

These and other matters are discussed in more detail below.

Issue 1 - Justification

SEGC agrees that there is justification for separating the functions of investor compensation and clearing and settlement support by way of a payment out of the NGF under section 891A of the Corporations Act.

SEGC has indicated in previous submissions that it considers that the removal of the clearing and settlement support role from the NGF is essential for future developments in financial markets in Australia. Reasons for this include the following:

1. *Risk monitoring and management*

   SEGC needs to know the risks to the NGF and to assess the likelihood of claims, so that directors can properly perform their duties as directors of a trustee company, and the Board can determine from time to time the Minimum Amount of the NGF. In order for SEGC to perform a proper risk assessment in relation to clearing and settlement support claims it needs to obtain detailed information from ASX and to be involved to a varying degree in most ASX projects so that SEGC is aware of proposed developments which may affect the risk to the NGF.

   Further, since the inception of the NGF in 1987 the volume of trading on ASX markets has increased significantly. For example, in the ten year period from 1993 to 2003 the average daily value of turnover in equities increased from $390.4 million to $2.242 billion (a change of 474%). Consequently, the measurement, monitoring and management of risk has become a far more complicated and critical task requiring specialist resources.

   In the future, the clearing system will be administered by Australian Clearing House Pty Ltd (ACH), which will also be the central counterparty. Hence, ACH will be far better placed than SEGC to obtain the necessary information and perform a proper risk assessment in relation to clearing and settlement support. Further, ACH is able to directly manage this risk. In view of this, it is appropriate that clearing and settlement support be provided by ACH.

2. *Administration of a default*

Under the present arrangements, if SEGC allowed a clearing and settlement support claim SEGC would become involved in the administration of the default because of its right of subrogation. In this situation SEGC would be almost totally dependent upon the knowledge, systems and information of ASX (and in the future ACH). Further, a default may occur at a time of general stress in the financial services industry when there are also insolvencies of market participants which give rise to claims on the NGF by clients of those participants. SEGC does not have the resources to administer a clearing and settlement default at the clearing house level as well as managing claims resulting from the insolvency of one or more participants.

For these reasons it would be more appropriate for the administration of a default to be the responsibility of ACH.

3. *New members of SEGC*

Currently, ASX is the only member of SEGC. However, other market operators can apply to become members. The complexities for SEGC identified above in respect of risk management and default administration would be magnified if there was more than one member of SEGC. SEGC would need to undertake risk management and default administration activities in relation to the clearing and settlement facilities of each member of SEGC. Confidentiality and conflict of interest issues would make it extremely difficult, if not impossible, for SEGC to perform this role, especially in the absence of any limits on the amount payable under the various clearing and settlement support claims categories.

4. *International comparisons*

All countries other than Australia separate the arrangements for clearing and settlement support from the arrangements for investor compensation in respect of conduct by market participants. Hence, no overseas compensation fund provides clearing and settlement support.

If the sole function of the NGF was to provide investor compensation the NGF would be more consistent with international compensation schemes.

Issue 2 – The calculation

In December 2001 the Board of SEGC retained PricewaterhouseCoopers (PwC) to prepare a report on the amount of assets to be retained by the NGF to meet investor protection claims in the event that a payment is made out of the NGF under section 891A. The PwC report, entitled National Guarantee Fund Assessment and Record of Underlying Analysis for National Guarantee Fund Assessment dated 29 October 2002, is Annexure "E" to ASX's application for a payment out of the NGF. A summary of the report is Annexure "F" to the application.

The identification, assessment and evaluation of key risk factors for the NGF by PwC was performed as at 27 March 2002 and the results of the report are effective as at that date. In view of this SEGC intends to have the report reviewed and updated prior to the proposed direction for a payment out of the NGF under section 891A. This will provide an up-to-date assessment as to the amount of assets which should be retained by the NGF to meet investor protection claims. It will also be necessary to take account of any outstanding or potential claims at the time of the Fund split.

SEGC will also provide updated figures as to the net assets of the NGF and the amount of Financial Industry Development Account funding approved by the Minister but not yet claimed.

SEGC is happy to discuss further the timing of the proposed payment out of the NGF and the time at which updated information should be provided.

Issue 3 – Capping of payments from the NGF

This issue was discussed in SEGC's submission of January 2004 in response to the position paper on compensation for loss in the financial services sector (and in previous submissions by SEGC). For ease of reference SEGC's submission on capping is repeated below.

SEGC strongly supports limiting payments from the NGF by imposing monetary caps. At present, there are no caps on payments from the NGF other than a cap of $11.2 million in relation to claims for property entrusted to a dealer that becomes insolvent. Hence, the NGF is exposed to potentially unlimited liability for claims.

As discussed in SEGC's submission of November 2002 in response to the issues and options paper on compensation for loss in the financial services sector a cap on payments would:

- ensure the structural soundness of the Fund and facilitate the actuarial calculation of the amount required by the Fund;
- reduce the moral hazard whereby clients take unacceptable risks in the knowledge that there are no limits on the compensation available;
- be consistent with external dispute resolution schemes which may impose monetary limits on claims and reduce the possibility of forum shopping;
- be consistent with international compensation schemes in the financial services industry which, as far as SEGC is aware, all impose monetary limits on claims.

Further, a cap on payments would be consistent with compensation arrangements under Division 3 of Part 7.5 of the Corporations Act to the extent that the rules for those arrangements may impose an upper limit on the amount of compensation to which a person is entitled in respect of a claim[1].

SEGC considers that a cap of $500,000 on payments from the NGF would be appropriate. A cap of this amount would not result in any substantial reduction in investor protection by the NGF. As discussed in SEGC's submission of November 2002 a cap of $500,000 would have limited payments from the NGF on only 4 occasions since the Fund's inception in 1987. Further, a cap of $500,000 is generous in comparison with most other international and domestic compensation schemes.

The submissions made in response to the issues and options paper on compensation for loss in the financial services sector indicate that there is widespread support for limiting payments from a compensation scheme either by imposing a monetary cap on payments from the scheme or by restricting access to the scheme to retail clients, or both. While these submissions did not relate specifically to the NGF they support the general view that there should be a limit on claims on a compensation scheme.

The Corporations Act provides that regulations may impose an upper limit on the amount of compensation to which a person is entitled in respect of a claim in particular circumstances[2]. For the reasons set out above, SEGC submits that regulations should impose an upper limit of $500,000

[1] Corporations Act, section 885E(3)
[2] Corporations Act, section 888C(3)

on the amount of compensation to which a person is entitled in connection with a claim on the NGF.

SEGC would be happy to discuss the drafting of regulations to impose a cap on payments.

In relation to the cap on the total amount payable in connection with claims for property entrusted to a dealer that becomes insolvent, the PwC report assumed that this cap will not fall below $11.2 million in real terms, regardless of the future Minimum Amount after the Fund split. On this basis, the cap should be a percentage of the Minimum Amount which gives approximately $11.2 million. When the PwC report is updated SEGC will seek confirmation that the amount of $11.2 million in real terms is still appropriate.

Issue 4 – Conditions

SEGC considers that the conditions proposed are appropriate.

Issue 5 – Draft Corporations Regulations

SEGC agrees with the draft amendments to the Corporations Regulations which are proposed.

SEGC considers that it is appropriate that broker/broker non-novated claims no longer be covered by the NGF. Broker/broker non-novated claims are in the nature of clearing and settlement support rather than investor protection. The intention of the Fund split is that the NGF will cover only investor protection. Further, the PwC report is based on the assumption that the NGF will provide contract guarantee protection only for claims by clients against brokers, and not for claims by brokers against other brokers. If the amount retained in the Fund is the amount proposed by PwC the NGF may not have sufficient funds to cover broker/broker non-novated claims. For these reasons, broker/broker non-novated claims should not be covered by the NGF after the Fund split.

Issue 6 – Proposed amendments to the Corporations Act in relation to levies

SEGC does not object to the proposed amendments which remove SEGC's power to levy ASX, provided that SEGC has power to levy all participants to which NGF protection may apply. As noted in the consultation paper, reforms in the ASX structure have the effect that a participant can be a clearing participant without being a market participant. Consequently, it is proposed that the NGF claims provisions will be amended so that NGF investor protection will apply in relation to clearing participants which are not also market participants. As the NGF will provide protection in relation to clearing participants, and as claims against these participants could result in a depletion of the Fund, SEGC should have the power to levy clearing participants as well as market participants.

SEGC supports in principle the capping of levies on participants. However, it submits that levies should not be capped while payments from the NGF remain uncapped. As discussed above, at present there is no limit on payments from the NGF (other than for claims for property entrusted to an insolvent broker) and hence the NGF is exposed to potentially unlimited liability for claims. It is therefore theoretically possible for a single claim or a series of large claims to wipe out all funds held by the scheme. This is an unsatisfactory situation as it undermines the ongoing structural soundness of the NGF. This problem would be compounded if levies on participants were capped as this would result in a situation where SEGC is exposed to unlimited liability for claims while its ability to raise funds is limited.

The type of cap which may be appropriate is discussed in SEGC's submission of January 2004 on the position paper on compensation for loss in the financial services sector.

SECURITIES EXCHANGES GUARANTEE CORPORATION

Submission in response to ASIC Consultation Paper 86: Competition for market services – trading in listed securities and related data

August 2007

Executive Summary

SEGC is pleased to have the opportunity to make a submission in relation to ASIC's Consultation Paper 86: *Competition for market services – trading in listed securities and related data* (the Paper).

One area yet to be addressed which is of particular interest to SEGC is the compensation regime provisions for financial markets in the Corporations Act (the Act) and Regulations appear not to be designed to deal with a situation where a participant of both Australian Securities Exchange[1] (ASX) and another market, can trade ASX securities on both markets. Accordingly, amendments will be required to deal with this situation.

Background

The National Guarantee Fund (NGF) was created in 1987 as a means of enhancing confidence in trading on the ASX. The NGF is a compensation regime under Division 4, Part 7.5 of the Act. The NGF is administered by the Securities Exchanges Guarantee Corporation Limited (SEGC), a non-consolidated wholly owned subsidiary of the ASX.

The funding arrangements for the NGF were originally created from pooling part of the assets of the fidelity funds formerly operated by state exchanges. Subsequently, interest from broker trust accounts and investment earnings has been added to NGF funds.

At present, the source of income for the NGF is investment earnings. Previously, interest from broker trust accounts was included in NGF funds but from March 2004 this interest is no longer available to the NGF.

Compensation arrangements – Divisions 3 and 4 of Part 7.5 of the Corporations Act and Regulations

Under Division 4 of Part 7.5 of the Regulations, the NGF provides investor protection by providing a means of redress for clients of stockbrokers in certain circumstances, including:

- where the broker has failed to complete a sale or purchase of securities entered into on the ASX's equities and debt market and where those transactions are required to be reported to the ASX by the stockbroker ('contract guarantee');
- where a stockbroker makes an unauthorised transfer of securities;
- where a stockbroker cancels or fails to cancel a certificate of title to quoted securities contrary to the operating rules of the ASX Settlement and Transfer Corporation Pty Limited (ASTC); and
- where a person has entrusted property to a stockbroker who subsequently becomes insolvent and therefore cannot meet its obligations to that person.[2]

The NGF is only available in relation to conduct of a participant of the ASX who enters into a reportable transaction[3] on the ASX. Other stock exchanges such as the Bendigo Stock Exchange and the National

[1] This body was formerly known as the Australian Stock Exchange.

[2] Respectively, subdivisions 4.3, 4.7, 4.8 and 4.9 of Part 7.5 of the *Corporations Regulations 2001*.

[3] As defined in regulation 7.5.01 of the *Corporations Regulations 2001*.

Stock Exchange of Australia.[4] have their own compensation arrangements. These compensation arrangements are governed by separate rules in Division 3 of Part 7.5 of the Act and Regulations.

A problem which may arise in relation to compensation arrangements is highlighted in section 885D, Division 3 of Part 7.5 of the Act.

Section 885D(1) was intended to ensure that there is a necessary connection with a particular market[5]. Under this section, if a loss could be connected to two or more markets all of which have Division 3 compensation arrangements, but it is not clear which, the client would not be entitled to compensation. Section 885D(2) provides if the loss could be connected to two or more markets, one of which has Division 4 compensation arrangements (ie the ASX market), but it is not clear which, the client may be entitled to compensation from the NGF. These situations could arise where the loss relates to the misappropriation of money or property held by a participant for a client in circumstances where the client is trading on more than one market.

The NGF provisions in Division 4 of Part 7.5 of the Regulations are drafted in such a way that they may cover losses even if those losses relate to trading on another market (ie the AXE market). In particular, Subdivision 4.7 of Part 7.5 (unauthorised transfer) applies where an ASX participant transfers securities without authority of a client. This is not confined to transfers on the ASX market. Hence, the NGF could cover a loss even if the unauthorised transfer occurred on another market (ie AXE market) by say an AXE participant, who is also a participant of ASX.

Subdivision 4.9 of Part 7.5 of the Regulations (claims in respect of insolvent participants) applies when a client entrusts property to an ASX participant. Hence, if a participant of another market (ie AXE), which is also a participant of ASX becomes insolvent then its clients could possibly claim on the NGF.

Conclusion

The uncertainty resulting from s885D is not in the interest of clients of participants of ASX or participants of another market.

[4] This body was formerly known as the Stock Exchange of Newcastle.

[5] Explanatory Memorandum to the Financial Services Reform Bill para 10.28.