Stockbrokers Association of Australia
Incorporating SDIA

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CONSULTATION PAPER – COUNCIL OF FINANCIAL REGULATORS: REVIEW OF FINANCIAL MARKET INFRASTRUCTURE REGULATION – SUBMISSION BY STOCKBROKERS ASSOCIATION OF AUSTRALIA

Preliminary Comments

The Stockbrokers Association of Australia is the peak industry body representing institutional and retail stockbrokers and investment banks in Australia. Our membership includes stockbroking firms across the spectrum, ranging from the largest wholesale stockbroking firms to medium-sized firms, and down to the smallest firms, having mainly a retail client base.

The Stockbrokers Association is pleased to provide this submission to the Council of Financial Regulators regarding its Consultation Paper: *Review of Financial Market Infrastructure Regulation of October 2011*.

The Stockbrokers Association's members have a strong commitment to maintaining the integrity and high standing of Australia's securities market and financial markets generally. We support the existence of a robust regulatory framework governing Australia's financial market infrastructure ("FMI"), and believe that ensuring the existence of such a regulatory framework is critical to the maintenance of the continued reputation and integrity of our markets.

The Association also believes that the right regulatory framework is vital to the future growth of Australia's markets and to fostering of Australia's role as a regional financial centre.

The Association agrees that a number of recent events have meant that it is timely that the Treasurer has requested a review of Australia's regulatory framework for its FMI. These events include:

- The trend of increasing merger activity between Exchange market operators globally, motivated by a desire to increase efficiencies especially through acquiring scale;

- The recent proposed merger between the ASX and the Singapore Exchange;

- The recent events involving the failure of the MF Global group which, although principally concerned with the failure of an intermediary, highlight the issues which arise where the failure of an overseas entity within a group impacts on a local group entity. This includes issues of insolvency, control and access to funds which may have been moved offshore. There would be no less potential for such issues to arise in connection with FMI groups.

In this context, the Stockbrokers Association is supportive of the FMI Review and its objectives.

At the outset, there are a number of fundamental propositions that the Association supports in relation to the FMI Review:

1. In order to ensure the continued high standing and growth of the Australian financial markets, and the important role which they play in wealth creation for all Australians, the appropriate regulatory framework must exist to guarantee the availability at all times of exchange market, clearing and settlement functions to investors.

2. Each of these services needs to be available to participants in a way which is not anti-competitive.

3. Subject to the above considerations, the potential for financial benefits flowing to Australian investors as a result of economic activity amongst the providers of exchange market services, clearing and settlement, including competition between providers and merger activity, can be considerable, and it is important that the regulatory framework does not shut Australia out from these potential benefits;

4. The Association is supportive of "step-in" powers to ensure the continued availability of key FMI services. However, careful thought needs to be given to the framing of the powers and their exercise, as they could have the potential to dissuade potential FMI entrants to our market, blocking the potential commercial benefit;

5. It is important that any unresolved FMI questions, particularly those relating to the provision of clearing, settlement and listing functions, be resolved so that any future proposals relating to individual FMI entities can be determined on relevant commercial considerations.

Set out below are some further comments addressing the individual Questions in the Consultation Paper.

Questions

Q1. Do you have comments on the location requirement proposal?

Q2. Do you have comments on the flexible, graduated approach for systemically important FMIs?

Q3. Do you have comments on the proposed mechanism to allow for the power to impose location requirements?

Because of the factors to which we have already referred above, and our comments, the Association agrees that power to impose a location requirement is an appropriate regulatory tool which needs to be available to regulators to ensure that systemically significant FMI architecture remains available to the market at all times.

There are however a number of complications which will need to be carefully considered in the framing and exercise of these powers. There may be an inherent tension between imposing location requirements, and some of the commercial benefits that that consolidation and competition in FMI services may offer.

In particular, the question of location of margins may be difficult. The recent events relating to the MF Global Group raise important issues about the geographic location of investor funds, including margins, and legal rules which govern the treatment of those moneys as a result. It is essential that moneys relied on for financial system stability, such as margins, be available in the jurisdiction when required. However, on the other hand, the ability of an FMI entity to reduce costs, such as by way of consolidating or netting of funds, may be one of the sources of economic efficiencies that could serve to reduce costs to end users overall.

Similarly, the high and increasing cost of information technology is one area where efficiencies will no doubt be sought by FMI entities. Imposing location requirements in relation to information technology would run counter to this.

There are no easy solutions which can be suggested to resolving some of these conflicts. There needs to be more detailed consideration given to these specific questions, and further consultation in relation to the framing of these powers and any guidelines as to how they are to be exercised.

Questions

Q4. Do you agree with the proposed power of pre approval of directors of FMIs and their parent entities? Are there alternative approaches you consider more appropriate? If so, why?
Q5. Do you agree with the adoption of a fit and proper standard similar to that in the Banking Act?

The Association does not have any issue with respect to these proposals.

Questions

Q6. Do you have comments on the proposal that ASIC be given an explicit power to direct a licensed market operator to make listing rules with specified content, with the consent of the Minister, where the making of that rule is appropriate for the enhancement and/or protection of market integrity?

In our submission, the importance of Australia's listing rules should not be underestimated.

The high standing and integrity of Australia's securities market owes a great deal to the robust nature of Australia's Listing Rules, and to the work of the Corporate Governance Council is setting high standards of conduct for listed entities. The work which has been carried out by the ASX in establishing and maintaining these standards has been of the utmost importance.

The Stockbrokers Association has always been steadfast in urging that these high standards be maintained. Investors are more likely to invest with confidence, both in the primary and secondary markets, when listed product meets these high standards.

The Association believes that the quality of listed product in Australia compares very favourably with that of many other markets, including some in our region. It would be detrimental for Australia's standards to fall for whatever reason.

For these reasons, the Association supports the proposal for a power to compel the making of a listing rule. This would be an important reserve power to deal with a situation where, for whatever reason, a gap in standards were to appear which the listing entity (whichever FMI that may be) was not willing to act in that regard.

One alternative would be for the function of establishing listing rules to be transferred to ASIC or some other dedicated body. That may remove the need for such a power to exist, if that body could be relied upon to pass the necessary listing rules. The Association does not presently see the need to consider this alternative, as there is no indication that the ASX will not continue to exercise the Listing Rule function which it has historically performed.

Questions

Q7. Do you have comments on the proposal to extend the power of directions to directors and officers of relevant licensees?

Q8. Do you have comments on the proposal to extend sanctions for failure to take reasonable steps to ensure compliance by the licensed FMI with a direction or condition onto an outsourced service provider which is a related body corporate, where the service provider is ordinarily (absent the direction) under an obligation to provide critical services to the FMI?

Q9. Do you have comments on the proposal that penalties for breach of directions or licence conditions be extended to all directions and conditions imposed by ASIC and the Minister on FMI licensees?

Q10. Do you have comments on the proposal that further sanctions be provided for in the Corporations Act for breach of directions and licence conditions?

The Association does not make any comment with respect to these proposals, other than in regard the proposal to make non-compliance a criminal offence. In our view, penalties for non-compliance should not extend beyond pecuniary sanctions.

Questions

Q11. Do you have comments on the proposal that either ASIC (in the case of an AML) or RBA (in the case of a CSFL) in consultation with the Treasurer could make the appointment of a statutory manager?

Q12. Do you have comments on the proposal that the relevant appointing agency should be able to appoint itself or a third party entity such as an individual, a professional services firm, or acompany, to step in and take over the operators of a systemically important FMI?

Q13. Do you have comments on the proposal that criteria identified in 8.1.3 are appropriate triggers for appointment of a statutory manager? Are there other criteria that should be considered? If so why?

Q14. Do you have comments on the proposed powers to be exercised by the statutory manager of an FMI and the proposed powers of the appointing regulator in relation to the statutory manager that are set out in Section 8.1.4?

Q16. Do you have comments on the proposal that the statutory manager should be obliged to operate in the best interest of overall financial system stability and market integrity?

Q17. Do you have comments on the proposal that all FMIs should be subject to step in unless exempted by regulators?

We are generally supportive of the existence of step-in powers, although we would want to see how those powers are framed in legislation before being in a position to comment more fully.

We would question whether appointing a manager in the case of a material outage would necessarily be the appropriate response. In the case of technical issues such as an outage, an externally appointed manager may not be the optimum way of addressing the situation, as opposed to cases of non-compliance or solvency issues.

In addition, whilst step-in powers may be the appropriate regulatory tool to deal with the failure of a systemically important FMI entity, there remains the question how effective the power will necessarily be in some cases. If a systemically significant FMI withdraws from the market, it may not be a straightforward matter for a regulator to intervene to arrange for that function to be replaced, or replace quickly, regardless of how widespread its step-in powers may be.

Questions

Q18. Do you have comments on the proposed criteria for designation of systemically important FMIs in Section 9.1.2? Are there any other criteria you consider important. If so why?

We have no additional criteria to suggest beyond the proposed list, which appears quite comprehensive.

Questions

Q19. Do you agree that the insolvency provisions of the Corporations Act should be amended to allow for timely portability of segregated client accounts in the best interests of financial system stability and market integrity?

The Association would support amendments that would enable portability of segregated client accounts. Facilitating the transfer of client positions so that clients are not prevented from managing those positions as they would like is a desirable objective. To the extent that transferring client positions may reduce the incidence of client positions being closed out earlier than the client would have wished, crystallizing a loss to the client, then this would be a further beneficial outcome.

Questions

Q20. Do you see any areas in which the governance of the NGF, or other arrangements under Part 7.5 could be improved?

Q21. If so, please explain why and how you think improvements can be made?

The National Guarantee Fund ('**NGF**') was established by the various State stock exchanges in the 1970's (which later formed the ASX) to protect clients from broker failures and defalcations. Originally it was funded by interest from stockbrokers' trust accounts, but since 2004 it has been self-funding. The Fund sits at $ 106m (as at 30 June 2011).

The trustee of the NGF is the Securities Exchanges Guarantee Corporation ('**SEGC**'), a company limited by guarantee whose sole member is Australian Stock Exchange Ltd. SEGC outsources the administration of the NGF to ASX. ASX charges SEGC for the operation and administration of the Fund.

The NGF and SEGC, and the compensation regime it administers, are governed by Part 7.5 Division 4 of the *Corporations Act.* The new market operator Chi-X commenced trading in ASX-listed securities in October 2011. However, while Chi-X will operate a market in the same stocks as ASX, it will have different compensation arrangements[1].

The Financial Industry Development Account **('FIDA')** is governed by section 892G and Regulation 7.5.88. It represents 'excess funds' that the Minister is able to distribute for appropriate purposes in excess of the actuarial limit for the Fund to cover likely risks. This limit has been assessed at **$76m**. Payments from the excess funds above this limit (also known as '*the FIDA Fund'*) must be authorised by the Minister.

Governance Arrangements of the NGF

In the Stockbrokers Association's submission, the introduction of competition in market services has crystallized a need to reconsider the governance arrangements for the NGF.

In the interests of transparency, and to remove any potential appearances of conflict, the position of ASX as sole member of NGF and responsible for determining its governance should be changed. As the Consultation Paper also identifies, the potential for ASX to be acquired by another commercial entity provides an additional reason for other arrangements to be made for the ownership and governance of the NGF.

We submit that as we near the multi-markets era in Australian securities exchanges, it is now an appropriate time to **review** certain aspects of the **NGF** (Division 4) compensation arrangements, in particular:

- the **ownership** and **corporate governance** arrangements of the SEGC as trustee of the NGF, and
- the criteria for the **distribution of excess (i.e. FIDA Fund) monies** in the NGF.

As to governance, we do not have any fixed views on the alternative arrangements that should be put in place. We would look to the Board of the SEGC being appointed by a suitably independent authority, which could be the RBA or ASIC, and the ownership structure of the SEGC settled along similar lines. However, any reform of the governance of NGF should not lead to it be being clothed in onerous requirements and procedures or it will become an expensive and inefficient bureaucracy which will have the net result of being a cost burden on the Fund itself.

[1] The Chi-X compensation arrangements come under Part 7.5 *Division 3* of the Corporations Act. The NGF arrangements come under *Division 4*.

Grounds for Compensation from the NGF

The Stockbrokers Association strongly urges that the NGF be retained for the purposes for which it was established. We would oppose any move to extend its application more broadly, or permit its funds to be used for purposes other than that originally specified. The amount of the balance sitting in the NGF is not unlimited, and could be tested if there were a default on a not-exceptional scale. We would therefore urge that the NGF not be utilized for purposes beyond its original remit.

We do not support any widening of the grounds for claiming compensation from the Fund. The NGF is a fidelity fund which provides cover in limited circumstances relating to on-market transactions. It is not a general compensation fund, able to pay compensation in the general sense, such as to satisfy court judgments or decisions of the Financial Ombudsman Scheme.

At only $106m if the heads of compensation were widened, the Fund would be rapidly dimished. There is presently some $4bn or more worth of transactions on ASX and Chi-X per day. (This figure, it is worth noting, is significantly lower than the daily turnover routinely seen prior to the current economic downturn, which was frequently around $6 billion per day)

Further, if claims in respect of financing arrangements were allowed – for instance standard or non-standard margin lending arrangements such as those arising from the failure of Opes Prime - the Fund will be quickly exhausted.

NGF must not be available as the 'default fund' such as that considered by R. St John in his 2011 report, upon which the Association has commented[2]. It is a special purpose fund which was built up from contributions from brokers for purpose of client protection. The corpus of the fund has been protected by the good governance and high compliance standards of stockbrokers, a fact which has been acknowledged by the SEGC in various Annual Reports.

While Pt7.5 of the *Corporations Act* does technically contemplate that other market operators could become members of SEGC[3], the fact that a. the Fund is effectively run

[2] *Review of compensation arrangements for consumers of financial services - Consultation Paper by Richard St.John* dated April 2011; Stockbrokers Association Submission dated 1 June 2011

[3] SECT 890A(3):

Minister to nominate the SEGC

(3) The Minister may only nominate a body corporate under subsection (1) if he or she is satisfied that:

(a) the Australian Stock Exchange Limited is a member of the body corporate; and

(b) each of the other members of the body corporate is a market licensee

by ASX and b. the new market operator Chi-X has chosen another route, preserves the status quo.

We would be happy to discuss any issues relating to this matter at your convenience. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3207 or email pstepek@stockbrokers.org.au .

Yours sincerely,

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