



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.