

SECURITIES EXCHANGES GUARANTEE CORPORATION LIMITED (SEGC)

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

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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 claim¹.

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 circumstances². 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.