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SUBMISSION
SECURITIES CUSTODY
AND
FINANCIAL INSTITUTIONS DUTY

Summary

Australia is still regarded as a relatively new and developing country which requires offshore capital to help develop and exploit its resources. Domestic capital alone is insufficient. In recognising this, consecutive federal governments have consistently sought offshore portfolio investment in the local equities and debt markets. This foreign capital adds substantially to the depth and liquidity of the Australian securities markets. The success of on-going federal and state asset sale programmes is also facilitated.

Custodians play an integral role in the functioning of the Australian securities markets. The \$400 billion of assets under custody held by members of the Australian Custodial Services Association (ACSA) attests the significance of their role.

In order to support the necessary interest in Australian portfolio investment, custodians have had to so structure their operations to shield investors from the impact of Financial Institutions Duty (FID), a transaction tax unlike any other in the world. Without the efforts of custodians, flows of foreign and domestic investment capital would have been substantially curtailed. Securities transaction costs in Australia would be a deterrent to many investors and their business would undoubtedly be directed elsewhere.

Custodians are concerned that any attempts to “reform” FID may intolerably impact upon their operations. Given the size and importance of the role of custodians, in the absence of any future total abolition of FID, we believe there are powerful arguments in support of exempting the custody industry.

Background

The term “custodian services” is used in this submission to describe financial transactions conducted by financial institutions either in the name of a nominee company on behalf of third party investors or where the financial institution itself holds securities and maintains accounts and other records of the financial transactions it has conducted in its capacity as custodian or agent for a third party investor.

For a variety of commercial reasons, individual and corporate investors will choose to hold investments using the name of a custodian trustee. The custodian trustee typically is a nominee company which acts as a bare trustee holding investments on behalf of the beneficial or equitable owner of the particular investment.

The nominee company may only enter into settlement transactions in response to authorised instructions of the beneficial owner of the assets or delegated representative such as the investment manager of a public unit trust. While the particular investment may be held in the name of a nominee company, the actual accounting records and account details may be retained within a financial institution that is registered for FID purposes.

These nominee companies are often special purpose subsidiaries of financial institutions, where the parent financial institution is registered for FID purposes. However, without the impact of FID, the opportunity would exist for a registered financial institution to conduct all financial activities on behalf of the third party investor, leaving the nominee company's role to simply be the registered owner or custodian of the nominated securities or investments.

Investors that use the services of nominee companies are typically institutional investors such as investment trusts and superannuation and pension funds or fund managers acting on behalf of these types of institutions. The institutional investors will often be non-residents. Also, many foreign central banks employ the services of locally based nominee companies to facilitate their investment in Australia.

As mentioned above, the reason for the use of the nominee company is to maintain efficiency in the performance of investment activities such as attending to the safe custody of securities purchased, collection of relevant income, attending to corporate actions, monitoring specific investor guidelines and reporting details of all transactions to the investing institution and/or fund manager as required.

We cannot stress strongly enough that the method of operation of custodian trustees in holding securities and other investments on behalf of both resident and non-resident investors is normal commercial practice in the wholesale money market place, a practice that existed long before the introduction of FID. The corporate and bank account structures now in place have evolved to ensure that FID did not have a too significant financial impact.

Currently, the transactional volumes processed by ACSA members in the conduct of custodian services exceeds many billions of dollars each month. Of this amount, a significant proportion is conducted on behalf of non-resident clients. Clearly these volumes indicate that nominee companies have a significant role in facilitating the practical manner in which foreign investment is conducted in Australia.

Existing State Taxation Concessions

There are a number of concessions granted within relevant legislation of the States, designed to alleviate any adverse effects that FID or stamp duty may have on investment activity.

In the stamp duty context, we note that each jurisdiction provides exemptions for certain marketable securities, including government, semi-government and corporate debt securities.

We also note that immediately following a decision by the Queensland Government to halve the rate of duty with respect to equity transfers conducted in Queensland, other state Governments matched this reduction in order to protect their share of the equity markets.

In the FID context, the role of stockbrokers as intermediaries in financial transactions is clearly recognised by excluding funds received to acquire securities, or as proceeds from sales of securities. By excluding these types of receipts from this definition, these receipts do not form part of the “designated receipts” of a broker that would be liable to FID.

Similar exemptions are also granted with respect to receipts of trustees or agents from the original issue of securities.

ACSA members strongly believe that the activities of custodians mirror those of stockbrokers, in that they are merely intermediaries who act solely on the instructions of investors in the wholesale financial markets.

State legislation also exists to provide concessions relating to foreign currency transactions. Specific exemption is provided for accounts used for foreign currency transactions, usually known as vostro accounts. These exemptions are understood by ACSA members to have been introduced to ensure that FID was not an impediment to the international dealings of both Australian financial institutions and other financial intermediaries.

The clear policy intention behind this exemption is to enable foreign investment to occur in a concessional manner, whereby the FID liability falls upon the receipt of the ultimate beneficiary of the foreign exchange transaction, rather than the financial intermediary.

Cost Impact of FID

The fact that Australia is the only country to apply a transaction tax to financial transactions is well known within financial markets. Its failure to satisfy the measures of a “good” tax have also been well publicised. In the context of the type of financial transaction conducted by custodian companies on behalf of their investors, the most fundamental problem relates to the stability of the tax base. In a world where more and more financial transactions are being conducted through electronic mediums, the transfer of custodian businesses outside of Australia is becoming increasingly feasible.

Attachment A details an analysis conducted by ACSA to compare the transaction costs with respect to an equity purchase conducted in 11 countries in the Asia/Pacific region. This schedule indicates that Australia has the third highest incidence of indirect taxes. While elimination of FID improves Australia’s position only marginally, there is the potential that elimination of the duty may lead to an increase in transactional volumes. This result is possible on the basis of recent research conducted by Professor Peter Swan, Sydney University and Professor Michael Aitken, Director of Sydney University’s Securities Industry Research Centre of Asia/Pacific. Their study indicated that a reduction in transaction costs leads within about 2 years to a rise in the volume of share transactions.

To date, custodians have been able to minimise the impact of FID for portfolio investors. This outcome is achieved as a result of structures that have been implemented to ensure that FID is not applied to every transaction conducted through a nominee company. The most basic structure to legitimately minimise FID is to maintain a separate entity that is a nominee company and is not a financial institution within the terms of the Act. The nominee company is then able to accumulate funds received from all transactions conducted each day and transfer that amount received to an account kept with a financial institution. This amount typically exceeds \$2 million allowing the maximum amount of FID payable on single transactions to be applied, thereby minimising the amount of FID paid on any one day to

\$1,200 in each state where custodian services are conducted. Maintenance of the separate company has its own costs that increase the cost of providing a conduit for foreign investment into Australia. Without the impact of FID, the conduit for investment could be within existing financial institution structures with an inherent reduction in overall cost of managing custodian activities.

The need to create a separate subsidiary to be able to offer services in a FID cost effective manner also acts as a barrier to new entrants to the custodian service business. This has been most clearly demonstrated by the specific exemption that was afforded to State Street Bank And Trust Co. by the New South Wales Government where it granted a FID exemption as an incentive for the company to locate its regional office in NSW. Although the exemption applies for a specified period of time, it recognises the barrier to entry that is presented by FID.

Impact of Real Time Gross Settlement

Custodians are aware of the proposed introduction of Real Time Gross Settlement ("RTGS") and, together with their bank (or their parent in the case of a custodian subsidiary) are considering the impact of RTGS on their operations.

As we understand it, the advent of RTGS will likely result in the diminishing use of bank cheques and large-value customer cheques, with arrangements being put in place to allow payments requiring immediacy and certainty to be made via electronic transfer.

Whilst wishing to support the move to electronic funds transfers, custodians are cognisant of the fact that it could lead to numerous electronic credits appearing in their accounts and negate their ability to aggregate funds received daily as they do today with physical paper receipts. FID costs are likely to escalate in an RTGS environment.

Conclusion

ACSA members believe that FID has an adverse impact on the efficient conduct of custodian services. Furthermore, the cost of FID has the potential to increase as some of the effects of electronic banking take effect in the provision of custodian services. This cost must necessarily be passed on to the users of custodian services. The cost and inefficiencies inherent in maintaining this type of service has the potential to adversely affect the status of Australia as an international financial centre as well as impeding the flow of capital investment into the country.

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ttachment A

ECURITIES TRANSACTING COSTS - ASIA/PACIFIC

example of USD 1 million equity purchase.

US Dollars

	<u>Australia</u>	<u>Hong Kong</u>	<u>India</u>	<u>Indonesia</u>	<u>Japan</u>	<u>Korea</u>	<u>Malaysia</u>	<u>New Zealand</u>	<u>Singapore</u>	<u>Taiwan</u>	<u>Thailand</u>
Brokerage	5,000	5,000	10,000	3,000	3,760	5,000	7,500	5,000	3,000	1,425	5,000
Stamp Duty	1,500	1,500	5,000	- **	-	-	- #	-	-	-	-
Exchange Fee	-	130	-	700	-	-	500	-	71	-	-
Registration Fee	-	-	-	2,500	50	-	-	-	-	-	-

Tax/Duty	600 *	-	-	100	-	-	-	-	- ***	3,000	-
Custodian Fee	30	100	100	85	25	30	100	40	100	100	96
	<u>7,130</u>	<u>6,730</u>	<u>15,100</u>	<u>6,385</u>	<u>3,835</u>	<u>5,030</u>	<u>8,100</u>	<u>5,040</u>	<u>3,171</u>	<u>4,525</u>	<u>5,096</u>

Potentially incurred if custodian is an F.I.

* Absorbed by broker.

** 3% GST on brokerage & clearing fee, local Investors only.

*** Charged per board lot certificate. Variable between security concerned. When scripless.
