# *ASX SUBMISSION*

# *FINANCIAL SYSTEM INQUIRY*

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**AUSTRALIAN STOCK EXCHANGE**

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# SUMMARY AND RECOMMENDATIONS

## The Role of ASX in the Australian economy

- A primary role of capital market participants such as ASX is to provide a market into which the savings of millions of Australians can be directed for investment by users of capital.

- The quality of our capital markets generally and their ability to compete with other forms of investment including international alternatives is a key component in successfully harnessing these savings, to foster Australia's economic growth.

- ASX conducts the 10th largest stock market in the world, measured by domestic market capitalisation (11th on the basis of turnover) and the 8th largest equity options market.

- Liquidity and scale are essential to ASX's role of marshalling savings (domestic and foreign) for investment. Investors will be cautious about subscribing to new capital raisings and placing their savings on Australian vis a vis foreign markets if they cannot be confident they can liquidate their investments readily and at low cost.

- Australia's domestic market capitalisation represents only 1.6 per cent of the Morgan Stanley Capital International world index. If our size and significance diminish so too will our capacity to attract international investors and retain domestic investment.

- The Australian market has a large number of smaller companies, with over 800 not represented on the All-Ordinaries Index. ASX is considering a number of options to assist small and medium size companies (SMEs). ASX is also concerned that aspects of the capital gains tax discourage investment in growth SMEs vis a vis other investments.

- The debt market in Australia is dominated by professional participants such as banks, life insurance companies, money market dealers and funds managers. These participants trade between themselves on an "over the counter" bi-lateral basis. ASX believes that an exchange based secondary market in debt would make the market accessible to "retail" investors who are at present denied access to a secondary market in debt instruments.

**Recommendation**

- The Inquiry should encourage the Federal Government to review the capital gains tax regime with a view to ensuring that a level playing field is operating with respect to investment in growth SMEs.

## The importance of saving

- ASX strongly endorses policies directed towards increasing national saving as an essential prerequisite to a sustainable improvement in Australia's economic performance.

- Private saving in Australia must be boosted, both to reduce Australia's undue reliance on foreign savings to fund investment and to respond to the demographic change findings outlined in the National Commission of Audit Report.

- ASX therefore urges the Inquiry to seriously consider options which will improve the rate and the allocation of private saving, noting that increased saving must be allocated effectively through the capital markets to ensure that higher private saving is translated into higher economic growth and employment.

- ASX recognises that the Inquiry has not been asked to re-design the taxation and retirement income systems and that the National Commission of Audit has recommended a comprehensive review of options for improving household saving, including in the area of superannuation. Nevertheless, ASX suggests the Inquiry could add to the momentum for reform.

**Recommendations**

- While recognising that the Inquiry's brief is not one of tax reform, the Inquiry's findings should nevertheless include support for a shift in the balance of taxation in Australia away from income and saving towards spending.

- The balance of tax incentives for saving should be shifted from 'compulsory' superannuation contributions towards voluntary forms of saving, including voluntary superannuation contributions and new superannuation-style products.

- The Inquiry should encourage the Commonwealth in studying the National Commission of Audit findings on retirement income and private saving to examine the following options:

  - ensuring that employee contributions are part of the Superannuation Guarantee system;
  - establishment of an appropriate target under the Superannuation Guarantee system for the replacement of pre-retirement earnings and minimal opting out provisions under the Superannuation Guarantee; and
  - phased extension of the Superannuation Guarantee to the self-employed.

## Competition and Technology

- The cost and complexity of technology presented an effective barrier to entry to new stockmarkets.

- ASX is now operating within a global competitive environment, where share trading is becoming international, Australian companies are listing on overseas exchanges and trading systems are becoming relatively cheap to build

**Recommendation**

- Regulators need to recognise that the quality of price discovery and the settlement system provided by ASX are not free public goods. Competitors must be required to compete equally and bear the costs of providing the same levels of security and integrity.

## Internationalisation

- ASX operates in a global environment. Australian investors can and do choose to direct some of their savings to competing overseas exchanges. Similarly, ASX attracts foreign savings into the Australian capital market, with foreign investors holding 32 per cent of Australian equities.

- Financial instrument trading no longer has regard to territorial boundaries. Foreign investors can choose which country's external deficit they will fund.

- The global nature of ASX's market environment can be seen from the fact that cross-border trading in equities accounts for one in four stock market trades made world-wide.

- Already between $20 and $30 billion a year of trading in Australian shares is believed to occur on overseas exchanges, a number that could grow rapidly if ASX does not remain competitive. Together with the increasing investment overseas by Australian investors, this puts the liquidity of the Australian market under pressure from the increasing globalisation of capital markets.

- A key strategy being pursued by ASX to remain internationally competitive is to establish liquid markets in foreign securities in Australia. Governments can assist by addressing issues of stamp duty, dividend imputation and establishment of regional funds management operations in Australia.

**Recommendations**

- The Commonwealth should work with State and Territory governments in agreeing on a scheme for the reduction and ultimately, the abolition of, stamp duty on transfers of quoted marketable securities. As part of this process, the Commonwealth should consider some form of compensation package which recognises the revenue foregone by States and Territory governments.

- As an immediate priority State and Territory governments should adopt the ASX proposal to reduce and ultimately abolish duties on the transfer of quoted securities of foreign companies listed on ASX.

- ASX proposes that the Income Tax Assessment Act be amended to permit foreign companies listed on ASX to operate franking accounts so that they can pay franked dividends to resident Australian shareholders out of profits that have borne Australian income tax at the corporate income tax rate.

- The anti-dividend-streaming provisions of the ITAA should be amended so that they do not apply to Australian subsidiaries of foreign companies listed on ASX

- Measures recommended by the APEC Capital Markets Working Group and supported by ASX include:

  – expanding access to the existing OBU offshore funds management tax concessions beyond licensed banks and foreign exchange dealer groups to all substantial international fund management groups that wish to operate in Australia;

  – expanding access to the existing OBU offshore funds management tax concession to cover fees derived from funds management back office and custody activities and for advisory services;

  – adoption by all States of uniform transaction tax exemptions and a dividend withholding tax exemption;

  – applying the existing OBU trust income exemption on a partial basis to trusts that conduct offshore investment for both offshore and onshore beneficiaries, and/or invest in both Australian and foreign assets;

  – simplifying some of the administrative and system obligations imposed by the existing OBU tax regime.

## Institutional Framework for Regulatory Agencies

- ASX has a strong commitment to ensuring the integrity of capital markets. The perception and reality of integrity is crucial to the successful conduct of our business.

- ASX recognises that regulation goes hand in hand with the perception and reality of market integrity. However, ASX supports a style and mode of regulation which

  – is efficient and cost effective for market providers, their customers (e.g. small and medium sized enterprises) and taxpayers and is therefore pitched at the minimum necessary level to ensure market integrity;

  – minimises regulatory duplication and maximises the amount of regulation which ASX itself can perform;

  – is responsive and flexible to ensure that capital market participants can react swiftly to market changes, and

  – in the specific case of stock exchanges, requires new entrants to meet the same regulatory requirements as ASX and pay fair access fees if ASX infrastructure is to be used.

- The super regulator and twin peaks models, organised on either an institutional or functional basis, are not supported by ASX. ASX believes that new larger regulators run the risk of becoming unresponsive monoliths with too many diverse functions. ASX would prefer to keep regulatory organisations as small as possible, to avoid running the risk of prejudicing responsiveness.

**Recommendations**

- The Inquiry rejects the super regulator and twin peaks models of regulatory rationalisation.

- The Inquiry support adoption of a formal lead regulator model under the auspices of the Council of Financial Supervisors (COFS);

- COFS be given formal status and the authority to implement a lead regulator model and to improve information sharing among regulators and to eliminate unnecessary regulatory overlap and inconsistencies. COFS should be headed by an independent chair;

- The Treasurer should be the Minister responsible for all regulatory agencies in the financial services sector.

- The Department of Treasury should have peak policy responsibility for advising the Treasurer on matters relating to financial services regulation. Treasury would need to establish a new unit which focuses on the relevant issues in an integrated way. It should be based near the markets. Each regulatory body should provide input to Treasury in relation to its area of responsibility. The new unit would provide the secretariat for COFS.

- A new national industry advisory body, the ‘Financial Markets Council’, should be established for the purposes of facilitating regular, high-level communication with the Treasurer and Treasury and as appropriate, other government Ministers and departments.

- Responsibility for competition policy should remain with the ACCC. However, the approval of an exchange’s rules should be the exclusive province of the Treasurer. The making and implementation of the business and listing rules of ASX be exempt from the provisions of Part IV of the Trade Practices Act. Section 51 of that Act provides for exemption from Part IV in respect of "arrangements" specified in and specifically authorised by an Act or regulation. The Trade Practices Act should not apply to regulated activities in the financial services sector (especially fundraising).

## Regulatory Philosophy of the ASC

**Recommendations**

- The ASC should be streamlined and its structure changed to focus on core, high-level activities. This could be achieved by :
  - privatising the bulk of its company information and record-keeping roles.
  - transferring responsibility for licensing and supervising exchange members to exchanges, and responsibility for registering auditors and liquidators to the professional accounting bodies.
  - moving it closer to a private sector type of organisation (eg., creating the position of Chief Operating Officer, having staff appointed under performance contracts, and adopting a fee-for-service basis for charging fees in some areas).
- The Minister should ensure that:
  - The ASC's aims more closely reflect those set out in its Act and incorporate specific reference to facilitating market development.
  - The ASC allocates a significantly higher proportion of its resources to its Regulatory Policy Division to work on issues relating to market development.
  - The ASC accounts to Parliament, through its Annual Report, on its performance in the market development area.

## The Burden of Regulation

**Recommendations**

- Based on the philosophy of ‘minimum regulation commensurate with the promotion of user confidence in financial markets’, a task force should review the balance of regulation across all financial products and markets to ensure that current anomalies are removed.
- When approving new stock markets, care should be taken to ensure that the regulatory system required of the market is appropriate not only in the context of the market itself, but also in the context of what is required of other markets.

## Regulation and the Corporations Law

- ASX believes that the Corporations Law is too long and too inflexible. It deals with subjects that it need not, and in relation to fundraising in particular, the difficulty of making forward-looking statements at reasonable cost, and the problem of overlap with s52 of the Trade Practices Act is impeding domestic competitiveness.

**Recommendations**

- As a high priority, a Treasury led task force should be appointed to urgently undertake a fundamental review of the Corporations Law with a view to the law being reduced to a high level policy document dealing with the core subjects of basic framework, takeovers, markets and intermediaries and fundraising.

- In undertaking its work the task force should:

  - base its review on the philosophy of 'minimum regulation' commensurate with the promotion of user confidence in financial markets;

  - review the balance of regulation across all financial products and markets to ensure that current anomalies are removed;

  - review the fund raising provisions to remove aspects which impede efficient capital raising through unnecessary regulation (such as the consequences of making forward-looking statements); and

  - take care to avoid an artificial and inefficient dichotomy between derivatives and securities. ASX considers that the optimal approach is a common regulatory regime for financial products (both securities and derivatives) with appropriate specific regulatory measures for individual product types according to the risks or other features of those products.

- The task force should be established as a high priority and be required to report within 12 months.

- The ASX suggests that the Inquiry lend its support to continued development of a Financial Arrangements Code in order to provide greater certainty and consistency to the taxation of financial arrangements such as derivatives.

## Risk Management, Uncertificated Holdings, Safe Custody and the Banking System

- The current settlement period for CHESS is trade day plus 5 working days (T+5) but in line with international recommendations, ASX is moving to introduce T+3. ASX supports a move to electronic funds transfer but presently most payments between brokers and investors are made by cheques which take 4 to 7 days to clear.

**Recommendations**

- Banks take steps to provide a generally available 'payment by telephone' service.

- Banks take steps to achieve the introduction of widespread electronic payment services.

- Government to take steps to legislate for a fully uncertificated environment for equities.

# 1. THE ROLE OF ASX IN THE AUSTRALIAN ECONOMY

## 1.1. An Overview of the Australian Stock Exchange

1.1.1. The Australian Stock Exchange was created in 1987 to amalgamate the six stock exchanges that had operated independently for more than 100 years in each of the Australian state capitals. ASX has built a national electronic order-driven equities market, with the six states linked by a sophisticated communications network that guarantees all of them equal access to the market.

1.1.2. In June 1996 ASX, together with the Sydney Futures Exchange and the Australian Investment Managers Association, published "Australia's Capital Markets", a report prepared by Dr Vince FitzGerald of the Allen Consulting Group ("the Fitzgerald Report").

1.1.3. A key purpose of the report was to explain how important, particularly for a country with a chronic deficiency of domestic saving, is the primary role that the markets play in channelling to productive investment both Australians' domestic savings and those from abroad.

1.1.4. The report suggested that the growth of Australia's long-term savings pool in managed funds, and the way in which we marshal capital to productive investment, is directly related to our ability to achieve growth in jobs and incomes.

1.1.5. The quality of our financial markets generally, and their ability to compete with international alternatives in a cost-efficient way, is a key component in achieving this.

1.1.6. Australia's stock market is the 10th largest in the world on the basis of domestic market capitalisation, and 11th largest on the basis of turnover. Even so, it represents only 1.6 per cent of the Morgan Stanley Capital International (MSCI) world index (which includes 22 mature markets around the world). The United States accounts for 41 per cent of the index, Japan 23 per cent and the UK. 9 per cent. In the Asia-Pacific region, Hong Kong has a 1.9 per cent weighting, Malaysia 1.4 per cent and Singapore 0.8 per cent.

| | **June 1996** | **5-yr growth** | **10-yr growth** |
|---|---|---|---|
| Domestic market capitalisation | $347 bn | 108% | 226% |
| Overseas listed equities | $219 bn | 237% | 691% |
| Total capitalisation | $573 bn | 145% | 330% |
| Number of listed companies | 1,184 | 8% | 10% |
| Turnover Value (12 months) | $159 bn | 192% | 407% |

1.1.7. The Australian market has performed very well over the past five and ten years, and in fact its return to investors has been considerably greater over ten years than the world average:

| | 5-yr growth | 10-yr growth |
|---|---|---|
| Morgan Stanley Australia Accumulation Index | +74% | +274% |
| Morgan Stanley World Accumulation Index | +80% | +199% |

1.1.8. ASX also operates the eighth-largest equity options market in the world. It trades options over more than 50 stocks and share price indexes, and in recent years has greatly increased the range of options traded to suit the varying needs of market users. As well as traditional options, the range now includes spot-month options, long-term options, flexible (or tailored) options and low-exercise-price options (which behave much like equity futures).

| | 12 mths to June 1996 | 5-yr growth | 10-yr growth |
|---|---|---|---|
| Option contracts (1000 shares) traded | 9.9 mill | -4% | 631% |
| Premium value | $3.3 bn | | |

1.1.9 Investor protection is also provided by the National Guarantee Fund, which provides three significant forms of investor protection:

- a mechanism for ensuring clearing guarantee for ASX markets and contract completion guarantee for clients;
- a mechanism for investors to claim compensation for the default, fraud or insolvency of ASX member firms in the circumstances set out in the legislation; and
- funding for significant systems development projects, through payments to the Securities Industry Development Fund, which have had the effect of reducing transaction risk on the ASX.

## 1.2. Capital formation and liquidity

1.2.1. Capital markets such as the Australian stock market create the price signals (yields and share values) which reflect up to date information available to market participants. These price signals in turn are the key to allocating resources marshalled by the capital markets to where they are most highly valued and productive.

1.2.2. If capital markets are not functioning smoothly, some productive investment could go unfunded or else companies would have to take on more debt finance and hence take on more risk. The stock market enables companies to share with investors both the risks and rewards from investment.

1.2.3. The stock market does not raise capital itself but by providing an efficient secondary market it plays a key role in facilitating primary capital raising. The Australian market has been used to raise, on average, $15 billion a year over the past four years to finance the growth of existing listed companies and new companies coming to the market. As a comparison, this equates to 60% of GDP growth over the same period.

1.2.4. If Australia is to become a financial centre for the Asia-Pacific region – and that seems to be an objective shared by Federal and State governments and the business community – then it must have a strong capital market. The FitzGerald Report identified scale and liquidity as the key factors determining the ability of capital markets to efficiently mobilise capital for investment.

1.2.5. The forecast growth in superannuation fund assets is a good example of the challenge confronting capital markets. FitzGerald estimates that, over the next ten years, superannuation assets are expected to grow in real terms at around 7-7.5 per cent a year, or around twice the rate of growth in the domestic demand for equity and debt capital (assuming such demand moves broadly in line with GDP or slightly faster as the capital intensity of the economy grows). As superannuation fund trustees and managers seek out high yielding investments (at acceptable levels of risk), the pressure will grow for Australia's capital markets to absorb those funds and put them to productive local use. Retention of those funds in Australia will require a larger and more liquid capital market.

1.2.6. Scale is essentially about attracting more companies, local and foreign, to list on ASX. Scale is important for a market to be able to retain the status of a distinct, well researched destination for portfolio investment, both domestic and international. As noted above, ASX has had some success in boosting the scale of our market over the past 5-10 years. Nevertheless, at 1.6 per cent of the MSCI, we are smaller than the Hong Kong market and just ahead of Malaysia.

1.2.7. Investors will certainly be cautious about subscribing to new issues unless they are confident that there is an efficient secondary market on which they can liquidate their investment if they want to – and do it quickly and at low cost.

1.2.8. A liquid stock is more desirable than one that is not. Investors, whether they are domestic or international, value liquidity, because if a stock is not liquid, it can be difficult, firstly to obtain any reasonably sized portion of the stock and secondly, to sell it at a later stage. Generally, with illiquid stocks, it is necessary to “pay more” and “sell for less”.

1.2.9. Market manipulation of stock prices is easier for illiquid stocks, as it costs less to move a market by 1 per cent or any other arbitrarily set amount.

1.2.10. Macro measures of liquidity aim to be standards that allow comparisons across industries and countries. Because in effect they average the liquidity of a range of stocks they should be used cautiously. ASX quotes in many of its publications the dollar value of turnover/ average market capitalisation, multiplied by 100. This measure is a standard measure for equity markets (as opposed to individual equities) and is used by the International Federation of Stock Exchanges (FIBV) to compare markets around the world.

1.2.11. Currently ASX is running at a liquidity level of 50 per cent, meaning that on average over the past 12 months, half of all the shares on issue on ASX have traded. Compared to other developed equity markets, ASX’s current liquidity is quite reasonable.

1.2.12. A more liquid stock market reduces the disincentive to invest in long duration projects because investors can easily sell their stake if they need access to their savings before a project matures. Enhanced liquidity facilitates investment in longer term, higher return projects that boost economic growth.

1.2.13. Factors which influence liquidity include information, transaction costs and market security and integrity

1.2.14. Readily accessible standardised information on listed companies, the market itself and the rules of trading are important for market participants. Ensuring that this information is available and accessed by areas outside of Australia is a challenge that faces ASX. In addition to the provision of standardised information, liquidity is improved if a market can attract a concentration of market analysts who research and publish detailed information about market sectors and individual companies. Attraction and retention of such analysts in turn requires a commitment by authorities to creating an environment conducive to establishing Australia as a financial centre.

1.2.15. The importance of accessible information was borne out by recent World Bank research by Levine and Zervos. After studying 16 developing countries, benchmarked against Japan, the USA and the UK, they concluded that wide dissemination of comprehensive information about a market's firms will result in a larger, more liquid and more internationally integrated stock market.

1.2.16. Most academic research in the area of transaction costs supports the proposition that lower transaction costs will lead to higher turnover.

1.2.17. The two main transaction costs for trading equities in the Australian market are brokerage and stamp duty. At an average brokerage rate of 0.32 per cent for institutional investors and stamp duty of 0.30 per cent on a round trip, these transaction costs put Australia at the lower end of competitiveness when compared to other developed markets and Australia’s neighbours in the Asia Pacific Region (see Section 4.7. for a discussion of the impact of transaction taxes).

1.2.18. Perhaps the most immeasurable and underrated of the above factors, the stability and integrity of a market, are important factors which are taken into account when making investment decisions. A large guarantee fund such as the one ASX operates provides surety for a transaction being executed with a broker.

1.2.19. A quality regulated market that has clear listing rules and is administered on a consistent basis provides integrity and confidence in investing. While it is difficult to measure this, fraud, corruption and high rates of settlement failure would all be illustrations of situations where there is little market security or integrity.

1.2.20. The World Bank research referred to above found that stock market liquidity is positively and significantly correlated with current and future rates of economic growth, capital accumulation and productivity growth. This research also found that stock markets provide different financial services from those of banks in order to positively impact on growth. Both stock market liquidity and banking development were found to be important to long run growth.

1.2.21. The scale and liquidity of our market is also inextricably tied to its composition. The Australian market is characterised by a relatively high proportion of resource companies (mining, oil and natural resource companies account for one third of the All Ordinaries Index), but there is a poor representation of growth areas such as telecommunications, infrastructure and utilities and small growth companies at or beyond the developmental capital stage. Institutional fund managers and private investors wanting to create a diversified portfolio which is representative of the Australian economy are therefore unable to do so. In order to gain exposure to these growth areas they may have to invest in overseas markets unless these growth sectors can be attracted onto the local market.

1.2.22. One of the impediments to gaining a more representative market is continuing government ownership of organisations such as Telstra and government's traditional domination of utility ownership and of the provision of infrastructure. While private utility ownership is becoming more common in Australia, few are presently listed but this can be expected to change when present owners seek to realise on part of their investment and/or to meet future capital needs. A number of major private sector infrastructure projects have recently listed on ASX. While large institutional investors have been direct investors in infrastructure projects in recent years, listing adds an element of liquidity to these investments as well as enabling a broader cross-section of investors to participate in this sector of the economy.

1.2.23. In recognition of the growing importance of this sector, ASX will launch in October 1996 a Utilities and Infrastructure Index. The creation of such an index, widely disseminated on a live basis throughout the day, enables market participants to monitor movement of this sector as well as collect statistics generated over the index.

## 1.3. Growth Small and Medium Enterprises

1.3.1. The overall liquidity of ASX is to some extent affected by the fact that the Australian market has a relatively large number of smaller companies listed on it. Well over 800 listed companies are not included in the All Ordinaries Index, although they are at least intermittently traded. (Over 90 per cent of the value of ASX turnover is in the 323 companies in the All Ordinaries Index). ASX is very open to small companies, with 825 listed companies having a market capitalisation of less than $40 million. In fact, it is possible for a company with net tangible assets of just $2 million to list - a limit much lower than can be found in other developed country exchanges.

1.3.2. Studies such as the Marsden Jacob "Financing Growth" Report confirm that growth SMEs are major contributors to economic growth, particularly in employment and exports. However, all the evidence suggests that when they seek equity investment for growth, the necessary capital is not readily or easily available.

1.3.3. Smaller companies, including those listed on ASX, are generally not very liquid. One contributing factor to poor liquidity is the difficulty in gaining investor interest from, say, a large funds manager, for whom economies of scale from larger investments is important. Another important factor is research and analysis. There is a lack of economic incentive to research stocks that are low in turnover, low in market capitalisation, and generate little revenue for intermediaries in the capital market.

1.3.4. This lack of investor interest and research of companies is an information gap and arguably a market failing. There is a second information gap because non-listed companies seeking equity investment and potential investors have difficulty identifying each other.

1.3.5. Marsden Jacob identified a gap in the supply of equity finance in the range from $0.5 million (the limit for so-called 'business angels') to $2 million (the minimum threshold for managed funds and also the minimum for ASX listing). They recommended this gap be addressed by: lowering search, information and transaction costs; facilitating matching services; and alternative equity exchanges. As noted above, ASX already has a very low listing threshold. A further reduction in this threshold will not help growth SMEs, with listing involving substantial initial and ongoing costs (eg prospectus, reporting, auditing). ASX believes that these companies in fact need a quite different mechanism for raising capital and securing a degree of liquidity.

1.3.6. ASX is therefore currently assessing whether the organisation's expertise in operating a secondary equities market could be applied to develop a market or other mechanism tailored for growth SMEs. At this stage no firm decisions have been as to how such a market might operate and whether it is both a worthwhile undertaking for ASX and likely to assist capital raising by these companies.

1.3.7. One option would be the establishment of a comprehensive matching service for equity seekers and equity investors, using the latest in information technology.

1.3.8. A second option would be to establish a facility for the quoting and trading of shares in SMEs - essentially an alternative stock market. Giving effect to the appropriate regulatory structure for such a market will require the co-operation of government and its regulatory authorities as well as education of investors to explain the precise nature of the regulation applying in this alternative market. These regulatory issues are discussed further in Section 8.1.

1.3.9. While the ASX is keen to play its part in addressing market failings in the channelling of investment funds to growth SMEs, Government can also play a vital role by ensuring that such companies operate on a level playing field in areas such as taxation, particularly capital gains tax (CGT). Aspects of the CGT regime which would appear to discriminate against investment in growth SMEs include the lack of rollover provisions, given that investors' returns from such companies tend to flow from capital gains (taxed at marginal rates) rather than from dividends (which attract imputation credits) in the growth stages. Risk taking equity investment is also discouraged by the fact that capital losses can only be offset against capital gains rather than all income.

## 1.4. Recommendation

**1.4.1. The Inquiry should encourage the Federal Government to review the capital gains tax regime with a view to ensuring that a level playing field is operating with respect to investment in growth SMEs.**

## 1.5. Debt market

1.5.1. A large number of debt securities are quoted on ASX, including virtually all Commonwealth, State and Semi-Government debt securities as well as a range of debt securities issued by commercial organisations. However only a very small number of these securities are traded on ASX. The value of debt securities traded on ASX annually has fallen from around $15 billion five years ago to just $100 million last year. It seems likely that the principle reason issuers seek to have their debt securities quoted on ASX is that quotation is necessary before some investors can buy the securities. This occurs when prudential requirements prevent investment in unlisted securities.

1.5.2. Debt instruments are an important part of the capital markets, especially in the light of the role the bond market plays in determining interest rates.

1.5.3. The debt market in Australia is dominated by professional participants such as banks, life insurance companies, money market dealers and funds managers. These participants trade between themselves on an "over the counter" bi-lateral basis. The nature of this market is that it is very difficult for investors other than professionals to access it.

1.5.4. ASX understands that participants in the professional debt market see little advantage in using a centralised market rather than the present bi-lateral arrangements. However ASX believes that an exchange based secondary market in debt would make the market accessible to "retail" investors who are at present denied access to a secondary market in debt instruments.

1.5.5. As part of its ongoing process of product review, ASX is reviewing the viability of an exchange traded secondary market in debt.

# 2. THE IMPORTANCE OF SAVING

## 2.1. The National Saving Context

2.1.1. A primary role of capital market participants such as ASX is to provide a market into which the savings of millions of Australians can be directed for investment by users of capital.

2.1.2. ASX strongly endorses the goal of increasing national saving, which it views as an essential prerequisite to a substantial improvement in Australia's economic performance.

2.1.3. ASX notes that, in respect of public sector saving, the State and Territory General Government sector is projected to operate in surplus for the rest of the decade while the Commonwealth Government is now projected to be a net lender to the rest of the economy by 1998-99 under the program of measures announced in the 1996-97 Budget.

2.1.4. Notwithstanding the importance of a successful return of the public sector to the status of a net lender, ASX is of the view that private saving (particularly by households) must play a significant role in reducing Australia's undue reliance on foreign savings to fund investment. It is acknowledged that the decline in the household saving ratio since the mid 1970s, from around 15 per cent of GDP to just over 6 per cent in 1994-95, has much to do with patterns of income growth, demographic trends and the economy's generally poor inflation performance. While some of these factors can be (and have been) influenced by macro economic policy, they lie outside the scope of this Submission.

2.1.5. ASX has noted with concern the projected demographic changes outlined in the Report of the National Commission of Audit (NCA), including the implications for Commonwealth pension outlays, of a dramatic increase in the age dependency ratio from the current 19 per cent to around 39 per cent in 2041 as the post-war so-called 'baby boom' generation progresses through retirement.

2.1.6. ASX urges the Inquiry to seriously examine options which will improve both the rate and allocation of private saving, noting that increased saving must be allocated effectively through the financial system to ensure that higher saving is translated into higher economic growth.

2.1.7. Major Australian institutions, namely life insurance offices and superannuation funds accounted for A$80 billion or around 25 per cent of the domestic market capitalisation of ASX. These figures are expected to rise in coming years, principally reflecting the operation of the superannuation guarantee charge.

2.1.8. ASX is attracting more private investors to the market. Ten years ago only a million Australians owned shares, five years ago it was 1.9 million, and eighteen months ago the number topped 2.5 million. This represents 21 per cent of Australian adults, who have around $60 billion invested in the market.

2.1.9. The broad coverage of the community by occupational superannuation funds means that an increasing number of Australians will be represented as indirect investors in the sharemarket.

2.1.10. While the Inquiry has not been asked to re-design the taxation or retirement income systems, clearly the interaction of these with the current and future operation of the financial system and capital markets cannot be ignored if the Inquiry is to make a meaningful contribution to improving the rate of saving and the allocation of those savings.

## 2.2. The Role of Taxation in Encouraging Voluntary Saving

2.2.1. ASX is supportive of measures to boost compulsory saving (such as the Superannuation Guarantee) in the context of an overall retirement income policy. However, Government needs to adopt policies which add to overall private saving by ensuring that the growth in compulsory saving is not offset by a decline in voluntary saving.

2.2.2. The tax system provides substantial tax concessions (estimated by Commonwealth Treasury at $5 billion) for superannuation. Such concessions were first introduced when superannuation was still largely a voluntary form of saving. With the introduction of the Superannuation Guarantee legislation, superannuation has increasingly become a compulsory form of saving, particularly for lower and middle income earners. While salary sacrifice arrangements may have provided an incentive for many higher income earners to increase their voluntary saving in superannuation, for the majority of the population, there is little incentive for voluntary saving out of discretionary income through superannuation and other savings products.

2.2.3. While Australia is not a high tax country by OECD standards, Australia raises a significantly higher proportion of its taxation revenue through taxes on income and therefore saving. ASX therefore encourages the Inquiry to lend its voice to the case for a shift in the balance of taxation in Australia, away from income and saving towards spending. Such a shift in the tax mix can be expected to underpin voluntary saving.

2.2.4. At a more specific level, the Inquiry could look at whether the balance of current tax concessions for saving, such as superannuation, should be shifted from the current support for what is effectively compulsory saving through the Superannuation Guarantee towards equitable incentives for additional voluntary saving such as genuine, voluntary employee contributions to superannuation. Such incentives could be provided on a revenue neutral basis so as to preserve the goal of increasing public sector saving. Such incentives could also be extended to new superannuation-style products such as the proposed Retirement Savings Accounts.

## 2.3. Recommendations

**2.3.1. While recognising that the Inquiry's brief is not one of tax reform, the Inquiry's findings should nevertheless include support for a shift in the balance of taxation in Australia away from income and saving towards spending.**

**2.3.2. The balance of tax incentives for saving should be shifted from 'compulsory' superannuation contributions towards voluntary forms of saving, including voluntary employee superannuation contributions and new superannuation-style products.**

## 2.4. Optimising Saving Through Superannuation

2.4.1. Commonwealth Government initiatives such as the Superannuation Guarantee legislation have seen superannuation become the fastest growing significant category of household accumulation. The current net annual flow of funds into superannuation is around $12-15 billion per year, with this inflow projected to grow to $25 billion per year over the next ten years. Of course, this inflow is resulting in a slower net flow into other non-superannuation assets. While these initiatives have successfully increased the level of superannuation saving and the coverage of superannuation (to an estimated 92 per cent of employees), overall household saving has continued to decline. It may be opportune, therefore, to examine whether measures could be taken to ensure that self-provision for retirement through superannuation is an even more effective instrument in boosting national saving.

2.4.2. In the 1995-96 Budget, the previous Federal government announced measures which would have the effect of lifting compulsory superannuation saving to 15 percent of average weekly earnings by 2002 (comprising an employer contribution of 9 percent, employee contribution of 3 percent and a government contribution of 3 percent in lieu of personal tax cuts). In the recent 1996-97 Budget, the new government indicated that it intended to implement measures similar to the 1995-96 Budget package, although the precise vehicle for delivery of the government's contribution was still to be determined. ASX strongly supports the inclusion of employee contributions as part of the Superannuation Guarantee.

2.4.3. Dr Vince FitzGerald in his 1993 *National Saving* report has suggested that contributions of 18 percent are required to bring Australian retirement incomes into line with international practice. At 18 percent FitzGerald estimates that employees would achieve 60 percent replacement of pre-retirement incomes without resort to the age pension.

2.4.4. Of course, bringing Australia into line with international practice will not make as effective a contribution to private saving while it remains possible under current preservation rules to run down tax-supported superannuation benefits and then qualify for an age pension.

2.4.5. The NCA Report suggests that 75 per cent of retirees will continue to qualify for at least a part pension (and associated Commonwealth benefits), in turn pointing to a continuing disincentive to boost pre-retirement saving to achieve self-reliance in retirement. For this reason, ASX does not favour extension of 'opting out' provisions for lower income earners under the Superannuation Guarantee.

ASX is also concerned that the trend towards forms of self employment, as an alternative to traditional wage and salary earner employment, could over time diminish the potential of the superannuation guarantee to lift private saving. It may therefore be timely to consider the phased application of the Superannuation Guarantee to the self-employed.

## 2.5. Recommendations

**2.5.1. The Inquiry should encourage the Commonwealth Government, in studying the National Commission of Audit findings on retirement income and private saving, to examine the following options:**

- **ensuring that employee contributions are part of the Superannuation Guarantee system;**
- **establishment of an appropriate target under the Superannuation Guarantee system for the replacement of pre-retirement earnings and minimal opting out provisions under the Superannuation Guarantee; and**
- **phased extension of the Superannuation Guarantee to self-employed persons.**

# 3. COMPETITION

## 3.1. Technology and history

3.1.1. Trading systems have traditionally been associated with stock exchanges, and grew from automating the processes of trading, centred around the trading floors of stock exchanges.

3.1.2. Trading floors developed as an efficient way of concentrating orders in time and place, in order to gain the best price. In time, rather than shouting out orders and writing on chalkboards, systems were developed which enabled traders to enter bids and offers electronically, while still communicating with others on the floor. A further refinement of this process enabled the same orders to be entered off the floor, from traders' offices. The system itself, however, inevitably belonged to the exchange, and brokers performed a pivotal role in first collecting, and then entering, orders.

3.1.3. Under a system where communications technology was expensive and unreliable, the cost of setting up a trading system was formidable, both in price and technological skills. There were considerable barriers to entry. Locating terminals in traders' offices required expensive and cumbersome communications links, and difficult, unreliable and expensive technology. This was the "first generation" of trading networks.

3.1.4. Responsibility for distribution of information was usually assumed by intermediaries, who would normally add value by processing exchange information and on-selling it to third parties.

3.1.5. This concentrated market was relatively easy to regulate and control. The central provider of the market had the support of the regulator, made the rules, ran the trading, provided settlement and controlled information flows. Regulation occurred within national borders.

## 3.2. The causes of change

3.2.1. We have seen a 'communications revolution' within the last ten years or so. The over-riding effect of this revolution is that access to a much improved global communications network is now available to a large portion of the population. The Internet has given ease of access and common global access to all participants, by joining independent users and suppliers as modules in a communications network.

3.2.2. It can now cost $3.50 per hour to connect to New York, whereas just a few years ago, it cost thousands of dollars just to log on.

3.2.3. "Moores Law" suggests that the ratio of computer processing power to price doubles every 18 months. As a result, trading systems, which were once time consuming and expensive to build, are now cheap and readily available, with greatly reduced natural barriers to entry.

3.2.4. Information can now be easily, cheaply and widely distributed to a much greater audience than ever before, and an inexpensive infrastructure is now in place. This has changed the rules in other information and media industries. Competition is now based on content (software) not distribution, and on adding value in the information chain. Technology allows for greater segmentation and product differentiation (marketers talk of a 'market of one'). The Internet has facilitated this.

## 3.3. Competition

3.3.1. The increasingly competitive global environment does not just mean a global shopping place, but global pricing of goods which do not require physical transport and delivery and the international pricing of, and competition for, capital. Competition is therefore no longer just domestic, but can be international.

3.3.2. ASX is operating within this global environment. Through the Internet, Australian residents can and do trade shares through US brokers on US exchanges. Australian companies can and do choose to list on overseas exchanges such as NASDAQ or the Vancouver Stock Exchange. Financial products are offered through the Internet. See also Section 4.2.

3.3.3. E-trade allows Australian investors to place orders through the Internet, directly with a US broker.

3.3.4. Oz-e-Mail, an Australian company, recently listed on NASDAQ because it believed that it could raise more money in the US than in Australia. This market has developed a critical mass of research and analysis in such stocks which provides investors with the necessary information to place their funds with new companies raising capital, even those from Australia. Interestingly, the Chair of Oz-e-Mail is reported as saying that a US listing takes longer, is more bureaucratic, has more legal hurdles, costs more and is only worth it if the company is seeking to raise more than US $20 million.

3.3.5. Representatives from the Vancouver Stock Exchange (VSE) have recently been in Australia extolling the benefits of a listing on VSE for small resource companies. The VSE claim that they can offer more capital to such companies than ASX is able to.

3.3.6. Competitors no longer have to compete on a full scale; nor can they be ignored if they compete only in a narrow segment of the business (eg. the Arizona Stock Exchange is competing with national stock exchanges in the US by running a call market by electronic open participation, once per day).

3.3.7. Open access to exchanges is becoming a reality. This means that orders can be entered into an exchange system automatically from a variety of trading systems and terminals, not necessarily just those controlled by brokers. ASX's new trading system "Seats '97" will allow brokers' own dealing systems to connect directly to the ASX trading system. Alternative trading systems are being provided by subsidiaries of information vendors (such as the Instinet system owned by Reuters) mainly for large institutions. Institutions are increasingly using their own systems to interface with their brokers.

3.3.8. As it becomes cheaper and easier to build a trading system, or trade on the Internet, the traditional role of brokers, and even of an exchange is under question. However, ASX believes that there is still a role for a central trading mechanism. As previously discussed, liquidity is a crucial factor in investors' willingness to trade through a particular exchange. The information created and disseminated by the exchange is a crucial component of maintaining that liquidity.

3.3.9. The creation of "price discovery" information is a complex and sophisticated process. It encompasses both the rules of the market, which ASX has developed over a number of years, as well as the rules and technological systems which govern trading and settlement, also created and developed by ASX. The interaction of these complex systems gives the price at which a given security trades. One source of revenue for ASX is its sale of this price information.

3.3.10. This information is not a free public good. In the same way that ASX would seek to ensure that competitors must should similar regulatory responsibilities for similar markets, (see Section 7.3.), it is also concerned that the information which is a key product of its rules and processes not be used by other organisations to "free ride" and to compete with ASX

## 3.4. Recommendations

**3.4.1. Regulators need to recognise that the quality of price discovery and the settlement system provided by ASX are not free public goods. Competitors must be required to compete equally and bear the costs of providing the same levels of security and integrity.**

# 4. INTERNATIONALISATION

## 4.1. Foreign Investment

4.1.1. ASX operates in a global environment. Australian investors can and do choose to direct some of their savings to competing overseas exchanges. Similarly, ASX attracts foreign savings into the Australian capital market.

4.1.2. Foreign investors play a key role in trading on ASX's markets and continued to increase their investment in Australian equities during 1995-96. During the year they purchased shares valued at A$34 billion. US and UK investors were again responsible for over 60 per cent of this activity. Hong Kong remains the third largest foreign investor on ASX although its share of foreign share purchases has halved to 10 per cent since 1991.

4.1.3. By March 1996 foreign investors held 32.5 per cent (A$ 109 billion) of Australian equities, an all-time high. This compares with 28.9 per cent two years earlier.

## 4.2. International competition for cross-border equity flows

4.2.1. With the advent of immediate access to information, instantaneous transaction capacity and certainty of settlement procedures, international funds flow in an unrestricted fashion. Financial instrument trading no longer has regard to territorial boundaries. Foreign investors can choose which country's external deficit they will fund.

4.2.2. Overall foreigners' holdings of institutional stocks now exceed US $1.5 trillion or 10 per cent of total world equity value. Cross-border trading (buying and selling) flows of equity capital have increased exponentially in recent years, and are now estimated to total between US $4 trillion and US $5 trillion a year. (The Financial Silk Road...A Fifth Wave of Global Money - Cross Border Equity Flows. a September 1995 Report by Baring Securities Global Strategy Unit.) Today, one in every four stock market trades made worldwide involves a foreign share or a foreign counterparty, compared to just one in fourteen in the early 1980s. Australia is competing with emerging markets for investors' funds. One in seven foreign equities held worldwide now comes from an emerging stockmarket, compared with one in two hundred only ten years ago. Baring Securities estimates that by 2010, emerging stockmarkets (including China, India, Brazil and Russia) will make up 45 per cent of world market capitalisation.

4.2.3. Cross exchange trading activity (buying and selling on exchanges local to the investor but foreign to the domicile of the underlying quoted company) is likely to grow in importance. Already between A$ 20 billion and A$ 30 billion of turnover pa. in Australian stocks takes place on overseas (principally UK and US) markets. If ASX does not remain competitive this figure could grow substantially. Indeed, some countries could see their capital markets effectively exported to New York, London or even onto the Internet. Greater liquidity and transparency, lower dealing costs plus increased ease and efficiency will exert a strong pull on institutional money towards global off-shore trading centres.

## 4.3. Regional co-operation

4.3.1. It is expected that the rate of growth of cross-border trading will continue as international investment funds expand and technology continues to develop at a rapid rate. While acknowledging that in some respects ASX is competing with regional stock exchanges, ASX believes that there is scope to co-operate with regional markets in areas of mutual interest. Stock exchanges in the Asia-Pacific region are facing similar issues in attracting investment funds on the basis of their size. Collectively the equity markets of Australia, Hong Kong, Malaysia, New Zealand and Singapore make up 5.8 per cent of the MSCI World Index which is considerably smaller than markets such as the UK (9.1 per cent), the US (41.5 per cent) and Japan (22.3 per cent).

4.3.2. ASX believes co-operation between regional exchanges can lead to harmonisation in regulatory issues which will ultimately reduce the cost of cross-border transactions. ASX is taking a leading role in exploring co-operative measures and is strongly advocating the adoption of International Accounting Standards.

4.3.3. An example of regional co-operation is the establishment of the Trans Tasman Index in a joint arrangement with the New Zealand Stock Exchange offering the first opportunity to see an aggregated performance measure of the Australian and New Zealand stock markets.

4.3.4. In addition ASX has also entered into separate Memoranda of Understanding ("MOU") with the Kuala Lumpur Stock Exchange and the Korea Stock Exchange. It is possible that further MOUs will be negotiated with regional exchanges. MOUs provide a mechanism for information sharing and initiating joint projects for the benefit of each country's capital market. It is hoped that they will ultimately lead to increases in cross-border trading between the countries.

## 4.4. Foreign Listings

4.4.1. ASX's key focus is on conducting efficient markets for the trading of Australian investment products for both Australian and foreign investors. In recent years ASX has also been seeking to provide a market where Australian investors, both private and institutional, can seek international exposure by investing in foreign companies listed in Australia. The establishment of liquid markets in foreign securities in Australia will provide a greater choice of investment products in Australia and contribute to growth in Australia's capital markets.

4.4.2. Excluding companies from Papua New Guinea ("PNG"), as at 31 July 1996 there were 51 foreign companies listed on ASX with a combined market capitalisation of A$ 217 billion. PNG listed companies are generally included as part of Australia's domestic market capitalisation, since ASX is the primary market for these companies.

4.4.3. Foreign listings are of two types: primary listings, where the company has its major listing in Australia, and secondary listings, where the company is primarily listed elsewhere, but also has a listing on ASX.

### 4.4.1. Primary Listings

4.4.1.1. Since 1993 ASX has been actively encouraging foreign companies, principally from the Asia Pacific region, to seek a primary listing on ASX. In February 1996, ASX launched its Asian Index comprising 26 ASX listed companies with 75 per cent or more of their business operations in Asia. These companies have a combined market capitalisation of A$ 1.2 billion. The majority have their business operations in China, but others operate in Indonesia, Malaysia, Vietnam and Singapore.

4.4.1.2. The liquidity in some of these stocks has been limited, and it is acknowledged that this market will take a period of time to fully develop. Many institutional investors have refrained from investing in these companies. Many of the companies are too small, institutions argue that they find it difficult to obtain independent research reports on the companies and they do not have access to their management. Some institutional investors are restricted from investing in foreign companies by their investment mandates and others have all foreign investments managed offshore.

4.4.1.3. There are, however, a number of Australian-based institutional investors who are starting to take an interest in investing in these companies. As this market develops ASX believes that some larger Asian-based companies, particularly from the mining sector where Australia has acknowledged expertise, will list in Australia and will attract institutional investor support.

### 4.4.2. Secondary Listings

4.4.2.1. This group comprises companies listed on ASX which have their main or "primary" listing on another exchange. ASX introduced the concept of "exempt foreign company" status which allowed large foreign companies that were listed on any of the fourteen ASC-approved exchanges to list on ASX with a minimum of effort and expenditure. This resulted in large multinational companies such as Phillip Morris Companies Inc (USA) and Cadbury Schweppes PLC (UK) listing on ASX.

4.4.2.2. Effective from 1 July 1996, the ASX Rules have been changed to make it easier for foreign companies to be listed on ASX as exempt foreign companies. The size criteria has been significantly reduced and the requirement to be listed on one of the ASC-approved exchanges has been replaced by the requirement for companies to be listed on any of the 48 FIBV Member exchanges.

4.4.2.3. Recognising the special economic relationship that Australia enjoys with New Zealand, ASX and the NZSE now mutually recognise each other's Listing Rules to make it simple for Australian and New Zealand companies to be listed on both exchanges. The size requirement for 'exempt foreign company' status has been removed for New Zealand companies.

## 4.5. Trading in foreign companies listed on ASX

4.5.1. There is a lack of liquidity in the market for many foreign companies with secondary listings on ASX.

4.5.2. The reasons for lack of liquidity in the trading of foreign companies with a primary listing on ASX were outlined above. The reasons given for lack of liquidity for secondary listings are slightly different in some respects and include:

- The most liquid market is usually the company's home market;
- Transaction costs are often cheaper in the home market;
- Inability of foreign companies to participate in CHESS; and
- Investment restrictions of Australian institutional investors.

4.5.3. ASX is developing Depository Receipts and CUFS (CHESS Units of Foreign Securities) to overcome some of these problems, particularly relating to settlement, that currently exist with the trading in foreign companies listed on ASX.

## 4.6. Key initiatives required to attract trading

4.6.1. If ASX is to attract liquidity in the trading of foreign stocks in Australia it is important to remove the disincentives for Australian investors to invest in these companies. Although it will be a more difficult task, the removal of the current disincentives may also encourage trading by foreign investors in foreign stocks listed on ASX

4.6.2. ASX believe that there are three critical issues which will need to be examined if Australia's capital markets are to remain competitive: stamp duty, dividend imputation and the establishment of regional funds management operations in Australia.

## 4.7. The impact of stamp duty on transfers of marketable securities

4.7.1. ASX has for many years urged State and Territory governments to abolish stamp duty on transfers of quoted marketable securities. Such duty places ASX at a competitive disadvantage with stock exchanges of foreign countries which do not impose stamp duty (eg. USA, Canada, New Zealand and Sweden) or impose duty at a lower rate (eg. Switzerland and Singapore).

4.7.2. By increasing transaction costs, Australian stamp duty impedes development of an internationally competitive securities market in Australia and is a disincentive for the listing and trading of securities of foreign companies in Australia. This is particularly so when the transfer of securities on the home market of a foreign company is not subject to duty, but the same transfer on ASX is subject to duty.

4.7.3. The far-sighted action of the Queensland Government in 1995 to halve duty on share transactions from 0.6 per cent to 0.3 per cent, effective from 1 July 1995, was an important initial step towards eliminating this major bias against the effective functioning of the Australian equities market. It also provided confirmation of ASX's long held view that a reduction or abolition of duty would increase trading volumes, market liquidity and therefore the level of savings through equities. Preliminary estimates by the Securities Industry Research Centre of Asia-Pacific (SIRCA) indicate that the volume of trading rose by 15% as a result of the fall in stamp duty.

4.7.4. When the New Zealand Government abolished stamp duty in 1989, the proportion of trading in New Zealand companies listed on ASX was reduced as liquidity flowed back to the New Zealand market. Research undertaken by SIRCA suggests that if stamp duty is removed from the trading of foreign securities, much of the trading in the leading New Zealand companies that is originated in the USA and the UK and executed on the NZSE would be redirected through ASX.

4.7.5. The abolition of duty on the transfer of marketable securities would bring significant national benefits:

- the additional transactions generated by the abolition would be subject to income tax or capital gains tax. Stamp duty represents an allowable deduction where marketable securities are held as trading stock or revenue assets. Where marketable securities are held as capital assets stamp duty paid on acquisition or disposal is included in the cost base. Abolition of stamp duty would reduce allowable deductions and costs bases relevant to trading in securities and therefore increase the amount of taxable income which is subject to Australian income tax;

- it would maintain Australia as the most liquid market for the securities of its own major companies;

- a more liquid market will encourage greater institutional investment in Australian equities (because of the ease of exit), encourage more companies to list and lower the cost of capital;

- greater liquidity will also encourage equity capital raising as opposed to debt - since equity capital is not repayable and is serviced only from profits, this will benefit Australia's current account;

- a liquid market is fundamental to the efficiency of the capital allocation process, which is a significant determinant of economic performance.

4.7.6. Abolition of stamp duty in Australia is complicated by the fact that it is a national problem but a State/Territory levy. It seems inevitable that the Federal Government would need to agree to pay some type of compensation to the States. The Federal Government could consider, for example, compensating disadvantaged States/Territories through the Commonwealth Grants Commission formula for calculating grants to them.

4.7.7. While ASX continues to lobby Australian State and Territory governments for the abolition of stamp duty for all marketable securities transactions, ASX places particular focus on transfers of quoted securities of foreign incorporated companies listed on ASX. While abolition is preferred, ASX has suggested that the rate could initially be reduced to .0025 per cent, commensurate with the rate of duty applying in NSW to transfers of securities by brokers acting as principal.

4.7.8. The revenue foregone from the abolition of duty on foreign securities has been estimated at $5.5 million for all States and Territories. This foregone revenue is hardly significant when viewed in the context of the boost it would give to Australia's aspirations of becoming a leading regional financial market.

4.7.9. This initiative forms part of a broader series of measures which represent ASX's response to the increasing globalisation of international financial markets. Competition for major listings and regional headquarters is intense. ASX believes that decisions about listing and locations of regional headquarters, given that all other factors are equal, will be driven by a relative cost.

4.7.10. ASX is seeking to work with Government to achieve a competitive cost structure to assist in the development of a successful international market . As part of this process, ASX has substantially reduced listing fees for foreign companies.

## 4.8. Recommendation

**4.8.1. The Commonwealth should work with State and Territory governments in agreeing on a scheme for the reduction and ultimately, the abolition of, stamp duty on transfers of quoted marketable securities. As part of this process, the Commonwealth should consider some form of compensation package which recognises the revenue foregone by States and Territory governments.**

**4.8.2. As an immediate priority State and Territory governments should adopt the ASX proposal to reduce and ultimately abolish duties on the transfer of quoted securities of foreign companies listed on ASX.**

## 4.9. Dividend Imputation

4.9.1. The introduction of dividend imputation in 1987, which removed the double taxation of dividends, was an important reform for Australia and its capital markets. However, the benefit of imputation at present does not extend to all participants in those markets.

4.9.2. The current imputation system creates a major bias against foreign companies listed on ASX competing for available investment funds from Australian investors. Profits of foreign companies which are subject to Australian tax do not generate franking credits and therefore dividends declared from such profits are unfranked in the hands of Australian shareholders. This contrasts with the position for Australian shareholders of resident listed companies and therefore represents a significant disincentive for foreign companies listing in Australia.

4.9.3. The value placed by the sharemarket on franking credits of listed companies has been assessed as at least $21 billion (McKinsey & Company, Capturing Value from Dividend Imputation (1994)) and is obviously a crucial component for investors in assessing after-tax returns on shares.

4.9.4. There is no sound reason for the imputation system to treat Australian tax paid by Australian companies different from Australian tax paid by foreign companies.

4.9.5. Removal of this inequity from the tax system would have significant beneficial effects for the Australian financial system, including:

- providing a major incentive for Australian investors to invest in foreign companies listed on ASX and having Australian operations;
- attracting additional foreign companies with Australian operations to list on ASX;
- further encouraging Australian institutional investors to allocate international investment funds to foreign companies listed in Australia; and
- encouraging more efficient allocation of available investment funds amongst Australian and foreign shares.
- providing an incentive to keep Australian investment capital which was earmarked for investment in foreign companies, in Australia;

4.9.6. The inequities caused by share schemes for employees of foreign companies are of particular concern. Australian employees involved in such schemes are disadvantaged not only by their companies' inability to pay franked dividends out of Australian-taxed earnings, but also because of the difficulties facing such companies in providing a satisfactory local market for the sale of such shares. Shares issued in Australia will tend to migrate to countries where a fully integrated system of dividend imputation exists. Consequently, any move towards increasing local ownership of foreign companies is likely to be frustrated.

4.9.7. ASX proposes that the Income Tax Assessment Act be amended so that franking credits be allowed for Australian tax paid on the profits of foreign companies listed on ASX which can be passed on to Australian resident shareholders upon distribution as dividends.

4.9.8. ASX encourages the investment by foreigners in Australian-based multi-national companies listed on ASX. At present dividend income from a foreign subsidiary of an Australian parent that is distributed by the parent to non-resident shareholders electing to receive unfranked dividends (known as pass through income) is subject to the anti-dividend streaming rules contained in the imputation legislation. This situation results in the loss of franking credits available to Australian parent companies upon payment of dividends to non-resident shareholders.

4.9.9. The distortions created by this situation are analysed in detail in the Bureau of Industry Economics Report 96/8, Dividend Taxation and Globalisation in Australia.

4.9.10. ASX agrees with the general conclusions of BIE in that report and with its recommendation that streaming of pass through income should be excluded from the anti-dividend streaming provisions.

4.9.11. ASX recommends that the anti-dividend streaming provisions of the ITAA should be amended so that they do not apply to pass through income distributed by Australian multi-national companies as dividends to non-resident shareholders.

## 4.10. Recommendations

**4.10.1. ASX proposes that the Income Tax Assessment Act be amended to permit foreign companies listed on ASX to operate franking accounts so that they can pay franked dividends to resident Australian shareholders out of profits that have borne Australian income tax at the corporate income tax rate.**

**4.10.2. The anti-dividend-streaming provisions of the ITAA should be amended so that they do not apply to Australian subsidiaries of foreign companies listed on ASX**

## 4.11. Establishment of regional funds management operations in Australia

4.11.1. ASX is part of a world-class financial services industry in Australia. The industry has a well-educated and multi-cultural skill base which daily trades financial products with skill not seen outside of New York and London. There is high-quality infrastructure in the legal and accounting professions which operate to standards equivalent to anywhere in the world and the information technology and regulatory areas are, on any view, leading edge.

4.11.2. Australia therefore has some of the important prerequisites necessary to attract foreign companies and capital, but we are not alone in this dynamic region in wanting to attract foreign companies and capital. The Singapore, Hong Kong, Malaysian and Taiwanese Governments are committed to developing their capital and financial markets to enable those countries to be more active and dominant in the region. Each has the ambition of becoming a regional financial centre.

4.11.3. ASX believes that Australia can and should encourage the listing of companies, location of corporate treasury, regional management and Offshore Banking Units ("OBU's") to this country. They will generate a flow of transactions through the banking system, increase liquidity in the capital markets and promote a closer involvement with APEC for the benefit of the Australian economy. ASX believes that if regional funds management operations could be attracted to Australia it could result in greater liquidity in the trading of foreign companies listed on ASX. The capacity of regional funds managers to undertake research into foreign companies (particularly those based in the Asia- Pacific) would be a key factor.

4.11.4. The report prepared by the APEC Capital Markets Working Group 'An Increased Australian Role in APEC Financial Markets' made the following observation

*"... The absence from Australia of regional portfolio management makes the listing of foreign companies in this country more difficult and discourages active trading in their securities. Australian institutions which run their Asian portfolios offshore (and that means most of them) do not see the Australian listing of a foreign stock as any incentive to include them in their portfolios (nor will foreign fund managers engaged by Australian institutions). Nor are they inclined to include these stocks in portfolios of 'Australian' equities , when asset allocation consultants and fund trustees punish those who do not stick with the crowd. The vicious circle is compounded by brokers who will not spend time on researching stocks with limited representation in institutional securities.*

*"Consequently we need some exogenous factor to persuade the Australian institutions that Australia is a good place to trade foreign stocks. This could be a foreign fund manager or foreign individuals who are sufficiently attracted by our advantages of trading system, clearance and settlement, banking, communications superior lifestyle and cost regulation to overlook any perceived negatives. More persuasive still would be official suasion directed at present or would-be managers of Australian superannuation money".*

4.11.5. Included in the report's recommendations was that Australian financial institutions must support the thrust to develop Australia as a regional financial centre. It noted that this requires a major and co-ordinated commitment which has not been forthcoming to date.

4.11.6. ASX concurs with the findings of this report. If Australia is to compete with Hong Kong, Singapore, Kuala Lumpur and Taipei to become a regional financial centre it must attract regional treasury and funds management operations to Australia.

4.11.7. ASX also supports the recommendations contained in the report which call for tax changes to remove impediments to the establishment of regional offshore management operations in Australia.

4.11.8. ASX also agrees with one of the key recommendations of the APEC Capital Markets Working Group's Report which stated that "Governments need to be convinced that development of regional financial facilities in Australia will widen, not weaken, the tax base" . The establishment of regional funds management operations in Australia will, in ASX's opinion, significantly benefit Australia's capital markets and the economy as a whole.

4.11.9. The ASX welcomes the Government's recent decision to allow OBUs that provide funds management activities to invest in Australian assets, subject to a 10 per cent limit (by value) on the Australian component of each non-resident's investment portfolio.

## 4.12. Recommendations

**4.12.1. Measures recommended by the APEC Capital Markets Working Group and supported by ASX include:**

- **expanding access to the existing OBU offshore funds management tax concessions beyond licensed banks and foreign exchange dealer groups to all substantial international fund management groups that wish to operate in Australia;**

- **expanding access to the existing OBU offshore funds management tax concession to cover fees derived from funds management back office and custody activities and for advisory services;**

- **adoption by all States of uniform transaction tax exemptions and a dividend withholding tax exemption;**

- **applying the existing OBU trust income exemption on a partial basis to trusts that conduct offshore investment for both offshore and onshore beneficiaries, and/or invest in both Australian and foreign assets;**

- **simplifying some of the administrative and system obligations imposed by the existing OBU tax regime.**

# 5. INSTITUTIONAL FRAMEWORK FOR REGULATORY AGENCIES

## 5.1. Present arrangements regulate competing activities and products differently

5.1.1. Regulatory agencies are usually (but not always) focused on particular classes of institution. The present regulatory framework for the financial services sector involves a number of different agencies. These include the Reserve Bank of Australia (RBA), Australian Securities Commission (ASC), Insurance and Superannuation Commission (ISC), Australian Financial Institutions Commission (AFIC) and Australian Competition and Consumer Commission (ACCC). These organisations came into existence at different times in response to different perceived needs. They have developed in response to particular events.

5.1.2. The charters (both explicit and assumed) of Australian financial services regulatory agencies and their relationships (both legal and cultural) with government reflect their different histories. Therefore, they vary widely. The approaches of the regulatory agencies to their various responsibilities also vary widely. A consequence is that institutions which undertake similar functions are subject to different regulatory regimes, and are regulated differently. As institutions compete across financial sectors more and more, the different regulatory approaches become more significant.

5.1.3. A good example is the regulation of collective investment products, which operates quite differently if the promoter is an insurance company (regulated by the ISC) or a fund manager (regulated by the ASC). Although efforts are being made to harmonise regulatory requirements, at least in terms of intermediary conduct (see, for example, ASC and ISC proposals to promote consistency in the regulation of investment advice - announced 12 March 1996), ISC- and ASC-regulated products often compete for the same investment dollar.

5.1.4. Applying different regulation to activities and products that are virtually indistinguishable, and are in competition, interferes with competition generally. It is likely to produce anomalous results for investor protection and distort economic decisions.

5.1.5. One possible solution is to identify particular functions and regulate them separately. However, a structure to do this may have difficulty coping with new products that do not fit into the existing functional boxes. Such products are occurring more and more. As well, ‘financial supermarkets’ (ie, organisations that offer a wide range of financial services) would be subject to numerous regulators, each with a different approach. Even in the current environment, dealing with numerous regulators is inefficient, time consuming and frustrating.

5.1.6. An alternative is to have one agency regulate all areas where these issues arise. In the main, the areas are:

- Licensing, conduct supervision and capital adequacy for banks, quasi-banks, insurance companies and investment brokers and advisers (including stockbrokers, futures brokers and insurance agents and brokers selling investment products).

- Offering documents in relation to all investment products, including collective investments and insurance products. (Because it is unlikely that a clear line can be drawn between offering documents relating to collective products and offering documents for other fundraisings, such a body would have to take on offering-document regulation for all fundraising.)

5.1.7. Such an agency would be, in many respects, a 'super regulator'. Another model, dubbed the 'twin peaks' approach would be to sweep the current regulators into two agencies, splitting the responsibilities along systemic risk and consumer protection lines. In effect, one new agency would be built around the RBA and AFIC, and a second agency around the ASC and ISC. For the reasons explained below, ASX does not favour either the 'super regulator' or 'twin peaks' model.

## 5.2. Capital adequacy may raise special issues

5.2.1. In a number of parts of the financial services sector, a key element of regulation is the imposition of requirements on participants to meet capital adequacy standards. Because higher capital adequacy requirements increase costs, imposing different capital adequacy requirements on different institutions can interfere with the competitive balance, particularly in areas where those institutions deal in similar assets or liabilities or offer competing products or services. Different capital adequacy requirements for different institutions distorts financial decision-making and produces anomalous results for competition, asset/liability structures and investor protection.

5.2.2. Like the development of regulatory agencies, different capital adequacy requirements have developed because of the different core businesses of banks, securities firms and life insurance companies. For securities and futures firms, the requirements have been struck on a 'gone concern' basis - that is, on the basis that the firm should be able to meet its obligations if it stopped business and its assets were realised in a short time period. For banks, the requirements have been struck on a 'going concern' basis - that is, on the basis that the bank will be able to meet its obligations if it keeps operating. For life insurance companies, the requirements have been struck on an actuarial basis - that is, taking account of the long-term liabilities that writing insurance business generates. Each set of requirements is administered by a different agency and each agency brings to bear a different approach.

5.2.3. In the late 1980s and early 1990s, there were concerted attempts to develop convergent capital adequacy requirements for banks and securities firms under the auspices of the International Organisation of Securities Commissions (IOSCO) and the Bank of International Settlements (BIS). They failed. However, it is likely that the attempts will be renewed eventually.

5.2.4. In ASX's view, different core businesses may well warrant the continuation of different approaches to capital adequacy, provided it does not distort decision-making as noted in paragraph 5.2.1. However, competition and diversification can be expected to increase and this suggests that it is important to ensure that similar requirements are imposed on similar activities.

5.2.5. This can be achieved by making one regulatory agency responsible for capital adequacy regulation (for example a new agency built around the Reserve Bank) or by existing agencies bringing their requirements into closer harmony. ASX favours the latter approach. Often, capital adequacy problems and other problems go hand in hand. A difficulty in one area can also alert supervisors to a difficulty in another. Separating capital adequacy regulation is likely to lead to poorer performance of the overall regulatory function, at least in the securities/derivatives area with which ASX is familiar.

## 5.3. Regulatory organisations need to be able to respond quickly to events in their areas of responsibility and to change.

5.3.1. Regulatory agencies must be able to respond quickly to transactions which have regulatory implications, to changes in industry structure, and to crises (or potential crises) in institutions. As the amount and pace of change increases (eg. through technology, internationalisation and innovation) response time will become particularly important.

5.3.2. Smaller organisations will, as a rule, be better equipped to respond quickly. As well, the staff of smaller organisations, especially at more senior levels, should be better able to focus on core matters than the staff of larger organisations.

5.3.3. The need to be able to respond quickly to complex events and environmental changes also suggests that regulatory organisations require highly skilled staff. However, there are real questions about whether a sufficient number of highly skilled staff can be attracted (and under-skilled staff shed) while the public sector employment paradigm applies. Because the financial services sector is better remunerated, it is especially hard for regulatory agencies to attract and retain quality staff. There is an increasing trend, especially in Asia, for financial sector regulators to employ their staff outside the normal public service paradigm, with employment usually being on a contract basis with remuneration at market rates. Many Asian regulatory agencies recoup some of the cost of this by charging on a fee-for-service basis.

## 5.4. The ‘super regulator(s)’ model

5.4.1. While clearly the current institution-based regulatory structure has its deficiencies, the Reserve Bank has properly cautioned against overstating the degree of blurring of different activities and products. Institutions are not offering the various products on the one balance sheet. Banks, for example, have separate entities offering collective investments, and this facilitates their supervision by different regulators. Because depositors, policyholders and investors have different legal claims, it would probably be difficult to merge them all into a single entity balance sheet which was supervised by a single regulator.

5.4.2. A concern held by ASX is whether a single regulator can effectively cover the full range of functions which may be offered by a single institution or by a group of institutions.

5.4.3. Brian Quinn, former Executive Director of the Bank of England, agrees there is a case for regulation organised around the functions of a financial system but points out that the necessary blend of skills and expertise is not easily come by. Reserve Bank Governor, Bernie Fraser, recently made the same point: "...the main problem with super regulators is that there are too few supermen (and women) to run them".

5.4.4. A number of countries have super-regulators which operate on an institutional basis. The Japanese example of a single regulator, the Ministry of Finance, is said to have not been without its problems of internal communication and co-ordination across its separate bureaus (banking, securities, insurance, and international affairs). Denmark, Sweden and Norway have single regulators for their banking, insurance and securities industries. Canada has a single regulator for banking and insurance. In practice, the supervision of banking and insurance tends to remain separate in such jurisdictions, reflecting the differences in the key functions performed, the structure of balance sheets and the risks involved.

5.4.5. Nevertheless, in the Australian situation, where financial regulation has continued to evolve (eg the Australian Financial Institutions Commission and the Council of Financial Supervisors were only established in 1992), the issue is whether the options of a single regulator or a rationalisation into two agencies would be an improvement (ie the costs and risks are outweighed by the benefits). ASX acknowledges that, for financial conglomerates, a two division super regulator may have some attractions when compared with their present requirement to deal with up to four regulators.

5.4.6. ASX would clearly be concerned if placing everything from the safest deposit to the riskiest investment under a single regulator resulted in a blurring of the risk spectrum of investments. The public cannot expect the same safety (as opposed to integrity) from equities as from a bank deposit.

5.4.7. In a sense, the ASC is ASX's super-regulator, performing regulatory functions handled by several bodies in some overseas jurisdictions. Adoption of the two division super regulator model described above would be likely to result in a splitting of current ASC supervision of ASX across both divisions. A new overarching management structure would also be installed. All of this change would move ASX's regulator further away from the marketplace. While ASX does recommend some greater focus for the regulatory activities of the ASC (see Part 6. below), we would be concerned that the leadership of a new regulator would lack an understanding of the special requirements of securities and derivative markets.

5.4.8. ASX also notes that there could be major difficulties in gaining the support of the States for the transfer of the functions of AFIC and the State-based supervisors of non-bank financial institutions (NBFIs) into one larger regulator. The States could legitimately argue that the NBFIs require a style of regulation more suited to the grass roots and regionally-based nature of the industry.

5.4.9. **The super regulator and twin peaks models, organised on either an institutional or functional basis, are not supported by ASX.** ASX believes that new larger regulators run the risk of becoming unresponsive monoliths with too many diverse functions. ASX would prefer to keep regulatory organisations as small as possible, to avoid running the risk of prejudicing responsiveness.

## 5.5. A 'lead regulator'

5.5.1. ASX recognises that the Inquiry may wish to deal with the problem of multiple and overlapping regulators confronting financial conglomerates. While not favouring a super regulator, ASX accepts that a 'lead regulator' could be assigned for each of the large financial groups which straddle the traditional sectoral divide between banking, securities and insurance. The lead regulator would be responsible for taking a group wide perspective on the risk profile of a financial conglomerate, and for co-ordinating the process of supervision on both a regular basis and in 'crisis' situations.

5.5.2. ASX understands that the Council of Financial Supervisors (COFS), comprising the RBA, AFIC, ISC and ASC, has been working on procedures to ensure that financial conglomerates and holding companies are effectively supervised. This could form the basis for implementation in Australia of a formal lead regulator model now applying in some countries where one member of COFS would have specific oversight responsibilities.

5.5.3. Under a lead regulator model, ASX would continue to deal with the ASC, although there may also be scope for some of the ACCC's functions to be performed by the ASC.

5.5.4. ASX also endorses the activities of COFS in removing impediments to information sharing among regulators and eliminating unnecessary regulatory overlap and inconsistencies for functionally similar products.

**5.5.5. ASX believes a formal lead regulator model is one it could support.**

**5.5.6. ASX would also support a more formal status and authority being granted to COFS to implement a lead regulator model and to improve information sharing and eliminate unnecessary regulatory overlap and inconsistencies. Under this more formal role for COFS, it would also be appropriate to appoint an independent chair to head the Council.**

## 5.6. Improved policy co-ordination by Government

5.6.1. In addition to improved harmonisation/co-ordination among regulators, ASX also is strongly of the view that overall financial sector policy co-ordination is required. This is properly the role of Treasury, which advises the Minister.

5.6.2. There are advantages in having a new single unit of government, within the Treasury portfolio but geographically based near the financial markets, doing this task. The effect would be to treat capital markets and the securities industry as a single industry, and bring together data and analysis on it. It would keep before policy-makers, in an integrated way, issues concerning the impact of government on the financial markets, the potential contribution of the markets to Australia's development, and how those inter-relate. It would bring together the regulatory agencies for the purposes of ensuring policy consistency. The various regulatory agencies would also provide policy input as they have a significant repository of practical experience to develop workable policy.

5.6.3. ASX envisages that the new Treasury unit would provide secretariat support for the upgraded Council of Financial Supervisors.

5.6.4. In addition to this new unit, a new industry advisory body, a 'Financial Markets Council', should be established to facilitate regular, high-level communication between the financial services industry and the Treasurer, Treasury and other relevant Ministers and government agencies. The new Council would have an independent chair and would comprise representatives of the financial markets, including ASX, the SFE, the "over the counter" markets and key market participants. It could help foster the development of a shared perspective, a shared sense of the potential for government to improve the environment for the industry, and a better understanding by the industry of the constraints on government.

## 5.7. Competition regulation

5.7.1. At present ASX's articles of association, business rules and listing rules are 'supervised' by the responsible Minister (the Treasurer). He has the power to disallow amendments. However, some of ASX's functions (eg., supervising members) are to some extent duplicated by the ASC, and some of the Minister's functions (eg., examining rule amendments) are duplicated by the ACCC (in relation to competition issues) and the ASC (which provides advice to the Minister through Treasury).

5.7.2. As discussed in ASX's February 1996 submission to the Office of Regulation Review on aspects of the Trade Practices Act restraining competition and business efficiency, ASX has concerns about the duplication of regulatory functions between the TPA and the Corporations Law. The suggestion was made in that submission that the making and implementation of the business and listing rules of ASX be exempted from the provisions of Part IV of the Trade Practices Act mainly because the public interest is sufficiently well served by one regulator, viz., the ASC. This is the model adopted in the United Kingdom. As the submission notes, the lack of timing constraints on the ACCC is a major cause for concern. The variations in time taken to approve proposals makes business planning difficult. Some approvals have taken as little as 3 months and some as long as 17 months.

5.7.3. The Trade Practices Act applies to, and the ACCC's responsibilities include, the financial services sector as well as other sectors. This produces some odd results, such as the NRMA case in which a plaintiff was able to use the Trade Practices Act effectively to override the Corporations Law - which has a carefully constructed prohibition on misleading and deceptive conduct and an attendant statutory defence.

## 5.8. Recommendations

**ASX recommends that:**

**5.8.1. The Inquiry rejects the super regulator and twin peaks models of regulatory rationalisation.**

**5.8.2. The Inquiry support adoption of a formal lead regulator model under the auspices of the Council of Financial Supervisors (COFS);**

**5.8.3. COFS be given formal status and the authority to implement a lead regulator model and to improve information sharing among regulators and to eliminate unnecessary regulatory overlap and inconsistencies. COFS should be headed by an independent chair;**

**5.8.4. The Treasurer should be the Minister responsible for all regulatory agencies in the financial services sector.**

**5.8.5. The Department of Treasury should have peak policy responsibility for advising the Treasurer on matters relating to financial services regulation. Treasury would need to establish a new unit which focuses on the relevant issues in an integrated way. It should be based near the markets. Each regulatory body should provide input to Treasury in relation to its area of responsibility. The new unit would provide the secretariat for COFS.**

**5.8.6. A new national industry advisory body, the 'Financial Markets Council', should be established for the purposes of facilitating regular, high-level communication with the Treasurer and Treasury and as appropriate, other government Ministers and departments.**

**5.8.7. Responsibility for competition policy should remain with the ACCC. However, the approval of an exchange's rules should be the exclusive province of the Treasurer. The making and implementation of the business and listing rules of ASX be exempt from the provisions of Part IV of the Trade Practices Act. Section 51 of that Act provides for exemption from Part IV in respect of "arrangements" specified in and specifically authorised by an Act or regulation. The Trade Practices Act should not apply to regulated activities in the financial services sector (especially fundraising).**

# 6. REGULATORY PHILOSOPHY OF THE ASC

## 6.1. Some regulatory organisations have diverse responsibilities.

6.1.1. ASX has had a very fruitful and constructive relationship with the ASC, which has been extremely responsive to ASX's business needs on a number of occasions. However ASX considers that the ASC has been given too many responsibilities to enable it to focus sufficiently on high-level, important matters. The matters for which the ASC is currently responsible include the following.

- Licensing and supervision of securities and futures brokers and advisers.
- Administering takeovers and share buy-back activities.
- Investigating possible market trading and corporate governance offences.
- Administering collective investment schemes and fund-raising.
- Keeping a huge data-base of company information, and other record-keeping.
- Registering auditors and liquidators.
- Playing various formal roles in corporate insolvencies, such as having residual assets vested in it.

6.1.2. Serious consideration should be given to whether all of these responsibilities are the ASC's ‘core business’. Some could be privatised (eg., keeping the companies database). Others could be delegated to the exchanges and various professional bodies (eg., licensing and supervising exchange members and registering auditors and liquidators), such bodies being subject to periodic audit in terms of any functions specifically delegated to them. In addition, steps should be taken to reduce duplication. For example, under the current Memorandum of Understanding between the ASC and ASX, the ASC continues to ‘on-site-visit’ ten ASX brokers each year. The same task has already been performed by ASX.

6.1.3. Changes of these sorts would significantly reduce the size of the ASC, enabling it to focus on high-level issues and improve its responsiveness. The ASC had (at June 1995) 1,551 staff, comprising 143 in the Office of the Chairman, 867 in Regional Offices, and 541 dedicated to information services. Currently total staff numbers are being reduced by 245.

## 6.2. Improving markets

6.2.1. Regardless of whether the above recommendations are accepted, there is a further issue concerning the ASC, namely regulatory philosophy, accountability and resource allocation.

6.2.2. In ASX’s opinion, the ASC’s present balance is not correct. In performing its functions and exercising its powers, the ASC must, under s1(2)(a) of the Australian Securities Commission Act 1989, strive:

*to maintain, facilitate, and improve, the performance of companies, and of the securities markets and futures markets, in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy.*

6.2.3. Broadly speaking, this should underpin a strong market development philosophy within the ASC. However a strong market development philosophy is not reflected in the ASC's activities as set out in its 1994/95 Annual Report. For example, its aim is set out as being:

*to protect the interests of companies and investors by providing information about companies, helping business to interpret the Law, and taking action against offenders.*

6.2.4. There is no mention of market development, or of its importance. The four chapters of the Report deal with 'Providing Information about Companies', 'Helping Business Interpret the Law', 'Taking Action against Offenders' and 'Delivering High Value Services'. In the 92 pages in the Report there is no mention of actions taken to facilitate market development.

6.2.5. The relative importance which the ASC places on the relationship between regulatory issues and market development is also reflected in its resource allocation policy. Of 1551 staff (June 1995), only 40 - or 2.6 per cent - are allocated to the ASC's Regulatory Policy Division, which is responsible for most of the matters relating to market development. (Such issues are not the Division's only responsibility however.)

## 6.3. Recommendation

**6.3.1. The ASC should be streamlined and its structure changed to focus on core, high-level activities. This could be achieved by :**

- **privatising the bulk of its company information and record-keeping roles.**
- **transferring responsibility for licensing and supervising exchange members to exchanges, and responsibility for registering auditors and liquidators to the professional accounting bodies.**
- **moving it closer to a private sector type of organisation (eg., creating the position of Chief Operating Officer, having staff appointed under performance contracts, and adopting a fee-for-service basis for charging fees in some areas).**

**6.3.2. The Minister should ensure that:**

- **The ASC's aims more closely reflect those set out in its Act and incorporate specific reference to facilitating market development.**
- **The ASC allocates a significantly higher proportion of its resources to its Regulatory Policy Division to work on issues relating to market development.**
- **The ASC accounts to Parliament, through its Annual Report, on its performance in the market development area.**

# 7. THE BURDEN OF REGULATION

## 7.1. Regulation is not free

7.1.1. It is a widespread misconception that regulation is a free good. It is not. Regulation provides benefits, but it is not well understood that there are costs, many of which are hidden. ASX takes account of this when setting requirements for its members and listed entities. The question of whether there is 'over regulation' is of general importance to ASX. It is a question of particular importance, though, in the context of the regulation of one financial service compared to another because of the implications mentioned earlier in paragraph 5.1.4. In this respect, ASX wishes to raise two major issues, namely the relative regulation of financial services, and the relative regulation of markets.

## 7.2. The relative regulation of financial services

7.2.1. ASX contends that the regulation of financial services is lop-sided. For example, there is a heavy emphasis on regulating the process of advising on acquisitions and disposals of securities, but little emphasis on similar processes for other financial assets or liabilities. S851 of the Corporations Law places quite onerous responsibilities on investment advisers in relation to advice they give on securities (eg., whether to buy or sell BHP shares). There is no equivalent requirement in relation to advice given for other categories of financial assets (eg., a bank bill) or financial liabilities (eg., a housing loan). It is not at all clear why the characteristics of securities should make the regulatory treatment of advice given about them so onerous compared with other products.

## 7.3. The relative regulation of markets

7.3.1. It seems clear to ASX that rapid developments in technology will create 'boutique' opportunities for other stock markets to emerge, although they must be approved to operate in Australia. In many respects this will be the natural order of things and is part of the normal competitive process in a dynamic economy. ASX would be concerned, however, if such new markets were not required to establish a supervisory framework suitable for the market which they operate (ie., wholesale or retail). Obviously the level of regulation might be quite low if the market is a wholesale, professional market. If there is significant retail involvement, ASX contends that any new market should be required to shoulder similar regulatory responsibilities to those required of ASX.

7.3.2. Supervision and surveillance of listed companies, for instance, is estimated to have cost ASX up to $13 million in the 1995/96 financial year.

## 7.4. Recommendations

**7.4.1. Based on the philosophy of 'minimum regulation commensurate with the promotion of user confidence in financial markets', a task force should review the balance of regulation across all financial products and markets to ensure that current anomalies are removed.**

**7.4.2. When approving new stock markets, care should be taken to ensure that the regulatory system required of the market is appropriate not only in the context of the market itself, but also in the context of what is required of other markets.**

# 8. REGULATION AND THE CORPORATIONS LAW

## 8.1. Structural problem of the law

8.1.1. A further dimension of the burden of regulation concerns the Corporations Law. ASX believes that the Corporations Law is too long and too inflexible.

8.1.2. ASX considers that the Corporations Law deals with subjects that it need not (eg., record keeping, annual returns, names and registration numbers, investment companies) and deals with a massive amount of detail which is not necessary (eg., s789 - register of licence holders, s792/793 - time for lodging annual report, s842 - contract notes, s845 - credit to employees, Part 7.5 - dealers accounts and audit requirements). The current Corporations Law is divided into 9 chapters, with no less than 87 Parts, and the Parts often have many Divisions. In connection with the Corporations Law Simplification project, it has been said that there were key principles which we needed to ‘rediscover’ in commercial law reform in Australia, and that:

*one of the problems with our commercial law is sheer bulk....But even more significant than reducing the text to manageable proportions is the new focus on important issues.*

8.1.3. Corporations Law Simplification is tackling a significant part of the problem by rewriting the Corporations Law in plain language, and addressing some structural defects. However, there are limits to a ‘simplification’ project. For example, in its June 1995 publication *Organising the Law,* the Task Force looked at converting the existing chapters into a larger number of smaller chapters (perhaps 31 or 43). A more comprehensive rethink of the structure of the law is needed.

8.1.4. A more comprehensive rethink could result in considerable extra flexibility. That flexibility would directly translate into a speedier response to market developments and new products. This has economic and investor protection advantages, which would add to the level of confidence in our markets.

8.1.5. ASX believes that greater flexibility is particularly needed in areas that will enhance Australia’s competitiveness. Two examples are relevant.

8.1.6. In the case of international competitiveness, if Australian entities were provided with the option of reporting using International Accounting Standards, the costs of fundraising and regulatory compliance in more than one jurisdiction would be reduced. The requirement to use (our excellent) Australian accounting standards is a costly indulgence. Australia represents only about 1.6 per cent of the world’s markets (Morgan Stanley Index), and major Australian companies are increasingly raising funds overseas. Australia cannot be a standard-setter. Moreover, our expertise could be more efficiently used in developing the International standards.

8.1.7. ASX has introduced a three per cent levy on annual listing fees in 1997 and 1998, in order to fund a project to progressively harmonise Australian and International accounting standards. The funds, likely to be about $1 million over two years, will be used by the Australian Accounting Standards Board and the Australian Accounting Research Foundation to progress the harmonisation project. ASX is also introducing an "account management" approach to larger listed companies, to ensure that issues impeding on their international competitiveness are dealt with at the appropriate level.

8.1.8. In the case of domestic competitiveness, the fundraising provisions are in urgent need of an overhaul. Although this is partly being addressed by the Corporations Law Simplification Task Force there are two particular issues, namely the difficulty of making forward-looking statements at reasonable cost and the problem of overlap with the Trade Practices Act (s52) that need some radical review.

8.1.9. The Corporations Law prohibits misleading and deceptive conduct in connection with the issue of a prospectus (s995(2)). However, in relation to a representation about a future matter, s765 reverses the onus of proof onto the maker of the statement to prove that the maker had reasonable grounds to make the statement. This is causing statement-makers to go to considerable expense as part of the due diligence process. Forward-looking statements are a useful addition to prospectuses. Indeed, s1022 may require them. But because of s765 the cost can often outweigh the benefit. The reason for the cost is that the liability is at an extremely high level, particularly for projections that cover a longer period. One problem is that an unmet projection (based on assumptions and calculations that seemed reasonable at the time) looks, with hindsight, much less reasonable. If a projection covers a 2-year period, it is estimated to add about 20-30 per cent to the cost of the due diligence. There should be a ‘safe harbour’ defence in relation to forward-looking statements.

8.1.10. It could be, for example, that if all reasonable steps were taken to ensure that the assumptions were reasonable, and the projection is transparent (including sensitivity analyses), there should be no need to reverse the onus of proof. The law should allow issuers of a prospectus to choose to make the projection’s assumptions and calculations clear.

8.1.11. The Trade Practices Act has many potential applications in the context of company and securities law. ASX has submitted to the Corporations Law Simplification Task Force that s52 should not apply to takeover documents and prospectuses in a way which defeats the statutory defences afforded in the specific provisions of the Corporations Law which would otherwise apply, and that civil liability in relation to documents similar to takeover documents and prospectuses should be reviewed.

8.1.12. In ASX’s opinion, the Corporations Law should be reduced to 4 core subjects, namely basic framework, takeovers, markets and intermediaries, and fundraising.

8.1.13. **Basic framework:** These are the mechanical and necessary procedural aspects of Corporations Law. They would specify a framework for beginning and ending a body corporate, some basic rules (eg. director’s duties) and give the courts jurisdiction. Offences would be set out in the law, although many of the current offences are of no practical regulatory significance and should be streamlined.

8.1.14. **Takeovers:** These provisions should remain, but be rewritten with far less detail. The ASC should have power to fill in the detail, and to modify all aspects of the provisions (within guidelines such as s731). The Takeovers Panel should be able to act quickly and in accordance with the intention and purpose of the provisions. In other words, the Panel should take on a character more like the UK City Panel.

8.1.15. **Markets and Intermediaries:** The securities and futures provisions should be merged, eliminating the distinction between types of product. As to the origin of the distinction see section 8.2. Instead, the Law should set up a broad definition of ‘Investment Business’ and ‘Investment Product’. Within that framework, the type of business, the persons authorised to conduct it, the markets for it, and the instruments that can be sold, can all be regulated. The tailoring of the details (eg. prudential requirements, conduct requirements etc.) can be left to the ASC (or other agency), the exchanges and other professional bodies. Such details can be set out in ‘rules’.

8.1.16. Investment Products could include, for example, securities, options, futures, collective investments, swaps, warrants and other derivatives, insurance products or whatever. The tailoring could take into account the level of sophistication of investors (eg. professional investors in $500,000 parcels need less regulatory intervention) and also the elements of risk. The detailed rules currently in the law about carrying on business as a stockbroker or futures broker could be covered by licence conditions and rules. For example, the broker behaviour rules referred to above (such as s789 - register of licence holders, s792/793 - time for lodging annual report, s842 - contract notes, s845 - credit to employees, Part 7.5 - dealers accounts and audit requirements) could be handled by setting up principles for broker behaviour in the legislation (eg. honesty, skill, client relations, financial resources) and allowing Exchanges or other professional organisations to regulate by making rules. Such rules would be subject to non-disallowance as are the existing rules of ASX. They could be enforceable under the ss777/1114 model.

8.1.17. The simplification of the Corporations Law in this way, to take account of these themes, rather than attempting to distinguish each new type of instrument, could increase investor confidence that there is consistency of treatment of investment products. The comments in the draft CASAC report of June 1996 on Regulation of On-Exchange Derivatives Markets at paragraph 1.20 refers to the uncertainty created by the current split between Chapters 7 and 8 for regulation of derivatives. The CASAC proposal improves the current situation but it substitutes a different distinction that is likely to be equally problematic. (see paragraphs 8.2.13. and following). If these broad definitions of 'Investment Business' and 'Investment Product' are linked to investor type and risk profile, then this consistency could be achieved. Distinguishing derivatives from securities would no longer be necessary at the Corporations Law level.

8.1.18. **Fundraising**: Earlier in this part of our submission ASX argued that the fund raising provisions are in urgent need of overhaul and identified two special areas of concern. ASX is concerned that the regulatory burden being applied to growth SMEs is both onerous and inappropriate. In a well functioning market, such companies will attract capital because of the higher return they offer investors. However, if the direct and compliance costs of regulation are too onerous then such companies have to pay an excessive premium for their capital.

8.1.19. There is a further issue. ASX has noted that the Government's *Innovate Australia - Finance* statement referred to a review of the fundraising provisions of the Corporations Law to ensure that small and medium sized enterprises and smaller investors were not unnecessarily impeded in the search process involved in matching investment opportunities with investment funds. ASX supports such a review and considers that it should form part of the suggested fundamental restructuring of the Corporations Law.

8.1.20. **ASX Listing and Business Rules**: Any fundamental review of the structure and content of the Corporations Law would provide the appropriate base for ASX to review its current listing rules and business rules within the same philosophy.

## 8.2. Derivatives

8.2.1. In 1985, a regime was introduced to deal with a particular need. That regime was the Futures Industry Act and Codes. It was introduced to provide a regulatory framework for the SFE and to stop ‘bucket shop’ fraud. The regime was stop-gap and for that purpose the distinction between securities and futures worked.

8.2.2. The new section (which was later to become Chapter 8 of the Corporations Law) was modelled largely on the Securities Industry Act and Codes (now Chapter 7 of the Corporations Law) with variations such as segregated accounts in place of trust accounts. In most key respects, Chapters 7 and 8 impose almost identical regulation.

8.2.3. There has been rapid growth in derivative products world-wide. Derivative products based on securities have been a part of this growth both in turnover and product type. Delineation between products which can clearly be regarded as futures contracts and derivative contracts which are currently regulated as securities has become increasingly blurred.

8.2.4. As product innovation continues, ASX believes that this convergence will continue to cause problems in a regulatory structure which seeks to demarcate products on the basis of either risk, product type or the market on which those products are traded.

8.2.5. As noted earlier, competition across financial sectors causes different regulatory approaches to become more significant. In Section 5. of this submission it was noted that applying different regulation to activities and products that are in many respects indistinguishable, and are in competition, interferes with competition generally. It is likely to produce anomalous results for investor protection and distort economic decisions. This applies to regulation of securities and futures.

8.2.6. The legislative amendments in 1995 which resulted in sections 72A and 92A of the Corporations Law were based on a recognition that existing delineation between products is at times arbitrary. Sections 72A and 92A recognised that regulatory regimes should enable business to be conducted responsibly with appropriate levels of investor protection. Accordingly, ASX was able to introduce share ratio contracts for trading on its securities market even though these products would generally be regarded as futures contracts under the current Corporations Law. The drafting of appropriate Business Rules and Corporations Law regulations ensured that there was no diminution in investor protection for investors trading in share ratio contracts on ASX's securities market.

8.2.7. Subsequently deliverable share futures contracts were approved for trading on a futures exchange under section 72A. Thus a contract which results in the delivery of shares in listed companies is now available for trading on a futures exchange.

8.2.8. In short, futures can now be traded on a securities market and securities can be traded on a futures market, provided the appropriate levels of investor protection and market supervision are in place.

8.2.9. Sections 72A and 92A which facilitated the trading of these products on their respective markets are regarded as an interim measure to provide a degree of flexibility while new laws are drafted to regulate the trading of derivatives in Australia.

8.2.10. The Draft Report on On-Exchange Derivatives Markets prepared by the Companies and Securities Advisory Committee (CASAC) and released on 24 June 1996 is the most recent initiative in the reform of derivative regulation in Australia.

8.2.11. The fundamental recommendation in the CASAC draft report is that the regulatory distinction between securities and futures contracts be replaced by a distinction between securities and derivatives. Under the CASAC proposal, there will be power to pass exempting regulations. There will be a "common understanding" exemption, which the

ASC can influence (a statement by the ASC that an agreement is not a derivative is prima facie evidence of that fact). The ASC can also exempt an agreement that is both a security and a future from either the securities or futures provisions (but perhaps not both).

8.2.12. The CASAC proposal is that a new derivatives chapter in the Corporations Law be drafted to deal with over-the-counter and on-exchange derivatives. It would replace the current Chapter 8 with additional or substitute provisions as recommended in the draft report.

8.2.13. Although ASX considers the proposed distinction between securities and derivatives is a more rational distinction than the existing distinction between securities and futures contracts, ASX has consistently expressed reservations about the fundamental concept of perpetuating the dichotomy between markets which has existed since 1985.

8.2.14. In Clause 3.4 of ASX's submission to CASAC dated 13 March 1996 we stated our concern that a derivatives/securities dichotomy is, in the future, likely to experience similar difficulties to those currently associated with the futures/securities dichotomy. We went on to note that these rigid distinctions create duplication of structures for market access, fidelity funds, clearing houses, etc. which are imposed on the market by the regulatory structure but which may not have existed otherwise. It is quite possible that the derivatives/securities distinction may become as outmoded in the near future as the securities/futures distinction now appears to be.

8.2.15. The CASAC proposals would re-categorise derivatives which are currently regulated as securities under the current Corporations Law. This includes exchange-traded options and warrants. They would become subject to a new Chapter of the Law and would be required to be traded on a derivatives market separate from a securities market. ASX's markets would be grandfathered under the CASAC proposal.

8.2.16. However, there are an increasing range of products and financial arrangements which have derivative characteristics, which ASX would submit, should continue to be traded as securities under the new regime. For example:

- Certain debt instruments which seek to replicate price exposure to particular securities (Qanmacs).

- Company options provide leverage and display derivation in that their fundamental pricing characteristic is based on the price of other securities issued by the relevant company.

- Margin lending arrangements which allow investors to gain leveraged exposure to securities and require payment of additional funds in the event of adverse market movement and require less funding in the event of favourable market movement can also be argued to be derivatives.

8.2.17. ASX does not want these products to be regulated as derivatives and as a consequence unable to be traded on a securities market. These instruments exemplify the anomalies which will continue to occur irrespective of the definition of derivative and security.

8.2.18. If one is to develop a sustainable structure for the regulation of financial products it may be more worthwhile to abandon the notion of separate markets. Instead a more fruitful path may be to permit the trading of all products on the same market whether securities or derivatives. Of course there would need to be appropriate regulatory measures in place to ensure proper investor protection commensurate with the level of risk identified with each product.

8.2.19. This would free up competition more fully between exchanges and at the same time enhance the ability for co-operation between exchanges in Australia. Both initiatives have the potential in the right circumstances to lower costs to market participants and enhance Australia's position as a financial centre in the region.

8.2.20. There is at present considerable uncertainty and inconsistency regarding the application of the income taxation legislation to financial arrangements such as derivatives. ASX supports in general terms the initiative of the previous Federal Government to introduce a comprehensive system for the taxation of financial arrangements on an accruals basis.

8.2.21. The legislative code resulting from this initiative should be as comprehensive as possible and flexible enough to accommodate the full range of current and future financial products. ASX will be making submissions directly to the Australian Taxation Office on the proposed Financial Arrangements Code but would welcome the Inquiry's support for continued development of the Code.

## 8.3. Recommendations

**8.2.1. As a high priority, a Treasury led task force should be appointed to urgently undertake a fundamental review of the Corporations Law with a view to the law being reduced to a high level policy document dealing with the core subjects of basic framework, takeovers, markets and intermediaries and fundraising.**

**8.2.1. In undertaking its work the task force should:**

- **base its review on the philosophy of 'minimum regulation' commensurate with the promotion of user confidence in financial markets;**
- **review the balance of regulation across all financial products and markets to ensure that current anomalies are removed;**
- **review the fund raising provisions to remove aspects which impede efficient capital raising through unnecessary regulation (such as the consequences of making forward-looking statements); and**
- **take care to avoid an artificial and inefficient dichotomy between derivatives and securities. ASX considers that the optimal approach is a common regulatory regime for financial products (both securities and derivatives) with appropriate specific regulatory measures for individual product types according to the risks or other features of those products.**

**The task force should be established as a high priority and be required to report within 12 months.**

**8.3.1. The ASX suggests that the Inquiry lend its support to continued development of a Financial Arrangements Code in order to provide greater certainty and consistency to the taxation of financial arrangements such as derivatives.**

# 9. RISK MANAGEMENT, UNCERTIFICATED HOLDINGS, SAFE CUSTODY AND THE BANKING SYSTEM

9.1. CHESS (the Clearing House Electronic Sub register System) provides electronic clearing, settlement and registration facilities for transactions in ASX quoted securities. It represents the third stage in a series of fundamental changes which have been implemented by ASX to make the settlement of ASX transactions more efficient and secure. A secure and efficient settlement system is crucial to minimising systemic risk in the stock market. Many of the changes have been implemented by ASX as a direct result of the recommendations made by the Group of Thirty in its landmark report (issued in March 1989) "Clearance and Settlement in World Securities Markets". (The Group of Thirty is a private, independent organisation whose charter is to raise awareness and understanding of major international economic and financial issues.)

9.2. CHESS enables participants in the clearing house (brokers, institutions, custodians, trustee companies, and private investors who are sponsored into the system by these entities) to hold most securities in uncertificated form on an electronic register of shareholdings. In CHESS, securities are transferred by electronic messages, replacing the need for paper documents to be used as the medium for settlement, transfer and registration. Holdings recorded on the CHESS subregister are recognised under the Corporations Law as if they were maintained by the company on its own share register.

9.3. The decision for shares to be held in certificated or uncertificated mode currently rests either with the issuing company (which may elect to have all of its securities uncertificated), or the investor, who may choose to hold certificates or become an uncertificated holder. To enable ASX to achieve its goal of being a highly competitive market internationally, it is imperative that certificates be phased out, in the interests of settlement efficiency. Government is requested to legislate for a fully uncertificated environment, allowing an appropriate lead time (say 3 years) for companies to comply with the requirement.

9.4. CHESS operates on the basis of Delivery-versus-Payment ("DvP") settlement; a key G30 recommendation. DvP is a highly automated electronic process which relies on the electronic transfer of uncertificated securities in CHESS and the transfer of cleared funds between banks (on behalf of CHESS participants) through the payments system operated by the Reserve Bank.

9.5. In keeping with the G30 recommendations, ASX intends to reduce the settlement period for ASX transactions to trade day plus 3 days settlement (T+3), which will require brokers to deliver legal title to securities against the payment of cleared funds on the third business day following the date of the transaction on ASX.

9.6. Settlement of ASX transactions presently takes place on T+5. Before T+3 can implemented it will be necessary to ensure that investors can transfer funds to their brokers prior to T+3, so as to enable brokers to meet their DvP obligations (using cleared funds) on T+3. At present, most payments between brokers and investors (other than those investors who themselves are direct CHESS participants) are made by cheques which take between 4 and 7 business days to clear. Unless brokers can "clear" clients' funds into their bank accounts by T + 3, banks will impose facility charges for meeting the brokers' payment obligation using cleared funds.

9.7. If changes are not made to the banking system to speed up the cheque clearing process (from clients), brokers will not be able to rely on cheques as an effective medium for payment under T+3. Consequently, ASX may not be able to introduce T+3 settlement. The Reserve Bank has indicated to ASX that it would not be pursuing this issue as a matter of priority, given its stance of moving towards greater use of electronic funds transfers rather than paper cheques. ASX supports the move to adopt electronic transfer facilities. However, such facilities will only provide a viable alternative if the banks are able to provide them at a reasonable cost to the investing public. ASX submits that it may be necessary for Government pressure to be applied to the banks in order to bring about reform in this area.

9.8. Another area where the technological efficiency of the banking system affects the operation of the securities industry is the safe custody of clients' money. Safe custody arrangements operate through requirements on brokers to separate clients' funds from brokers' funds. The clients' funds must be kept in a bank trust account.

9.9. However, a number of practices associated with the payment mechanism of banks inhibits the efficient operation of the trust account mechanism. The problems are the lack of a widely available electronic funds transfer mechanism, and the time it takes for funds to be cleared through the payments system. The outcome of these inefficiencies is higher operating costs for brokers.

9.10. There are two sides to the problem, the nub of which is as follows.

9.11. In the case of a purchase of securities for a client, funds from the client are not always received in a timely manner (because of the use of the 'cheque through the mail' system). The broker must settle according to a strict timetable and therefore the broker funds the client's purchase until it receives the client's money.

9.12. In the case of a sale of securities for a client, commercial practice often requires the broker to settle (eg. with an institutional client) on receipt of the securities from the client. However, the funds to pay the (selling) client will not have been received from the purchaser of those securities (through the netting system). Therefore, to pay its (selling) client the broker must use its own funds from its general bank account. Once the funds have been received through the netting system, there are legal problems associated with the broker reimbursing its general account from the trust account before the (selling) client has presented, and had cleared, the cheque paid to it by the broker. The effect is that the broker bears a cost (for example, opportunity cost) of funding the transaction during the period before the broker's cheque is presented and cleared.

9.13. The problem could be alleviated to a considerable extent if the 'cheque through the mail' system were replaced by a mechanism which resulted in a more timely receipt into brokers' trust accounts of payments from clients. If such amounts were received into the brokers' trust accounts in time for the brokers to meet T+5 (or T+3) settlement obligations, there would be sufficient funds in the brokers' trust accounts to pay amounts due to clients for the sale of securities (which were due for settlement and were settled, on that day). This would largely avoid the need for the methods currently adopted by many brokers of paying clients from the general account and then reimbursing the general account from the trust account.

9.14. The means of achieving a more timely receipt of funds into brokers' trust accounts is for banks to provide more widely a 'payment by telephone' system (ie. one for clients to use). Currently these systems appear to be made available only by brokers which are owned by banks providing the 'payment by telephone' service. For example, one bank is now offering its Direct Electronic Funds Transfer payment system to brokers. It enables clients to pay for shares by telephone transfer from any bank account to the broker's account. To participate the broker, who pays the fees, must be a customer of that bank. See *The Sydney Morning Herald* 14 June 1996. The development of a viable and generally available 'payment by telephone' system needs to be encouraged.

9.15. At the same time, banks should also take steps to achieve faster standards in providing 'cleared funds' into accounts. This would reduce the time brokers have to wait before being able to reimburse the general account from the trust account (eg. in relation to any residual payments).

## 9.1. Recommendations

**9.1.1. Banks take steps to provide a generally available 'payment by telephone' service.**

**9.1.2. Banks take steps to achieve the introduction of widespread electronic payment services.**

**9.1.3. Government to take steps to legislate for a fully uncertificated environment for equities.**

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