
Securities Exchanges Guarantee Corporation Limited

Submission to the Financial System Inquiry

Contact Details

Christine Jones
Manager SEGC
Level 11, 20 Bond Street
Sydney NSW 2000

Tel: (02) 9227 0408
Fax: (02) 9227 0436

TABLE OF CONTENTS

Executive Summary	1
Part A: Factual Summary	3
1. Introduction	3
2. Evolution of Investor Protection Funds in the Australian Securities Industry	4
(a) Developments since the Campbell Inquiry	4
(b) Current Investor Protection under Part 7.10 of the Corporations Law	4
(c) SEGC Relationship with the ASX and ASC	6
3. Performance of the National Guarantee Fund	6
(a) Source of Funds	6
(b) Claims History	7
(c) Management of the Fund's Assets	7
(d) Development Funding through SIDA	8
4. Risk Assessment for the NGF	8
5. Investor Protection in Other OECD Countries	9
(a) International Investor Protection Arrangements	9
(b) Comparison Matrix	11
(c) Recent Developments	11
Part B: SEGC Role in Current and Future Industry Developments	13
6. Expansion of Risk Underwritten by the Fund	
(a) SEGC Current Role	13
(b) Growth in ASX Market Activity	13
(c) Expansion of StockBroker Activities	13
(d) A New Exchange As a Participating Exchange Of SEGC	13
7. The Significance of Regulation	14
(a) SEGC Dependence on Regulatory Quality	14
(b) Proposed New Structure of ASX	14
(c) A New Exchange as a Participating of SEGC	15
Attachment 1: Comparison Matrix of International Investor Protection Funds	16

EXECUTIVE SUMMARY

- Part A of this submission presents a factual summary of the operations of Securities Exchanges Guarantee Corporation Limited (SEGC) in its management of the National Guarantee Fund (NGF), and includes a comparison with investor protection arrangements in overseas jurisdictions.
- “Investor protection” on Australian Stock Exchange Ltd (ASX) is achieved through a combination of federal legislation, supervision by the ASC and Department of Treasury, self-regulation by the ASX, stockbroker management practices, and the NGF.
- The NGF was established in 1987 and provides specific forms of investor protection for clients, brokers, the Securities Clearing House and Options Clearing House under Part 7.10 of the Corporations Law.
- The NGF contributes to the maintenance of market confidence in ASX by providing, under the specific circumstances defined in Part 7.10, a clearing guarantee for ASX markets, a guarantee of contract completion for clients and a fidelity fund against which clients of member brokers can claim compensation for the default of a broker.
- The majority of past claims on the NGF resulted from the insolvency of seven stockbroking organisations following the 1987 market crash.
- The Board of SEGC is responsible for determining the Minimum Amount of the Fund and ensuring that fund assets meet the Minimum Amount.
- The NGF has contributed to the development of the securities industry in Australia through payments to the Securities Industry Development Account (SIDA), as authorised under Part 7.10.
- Investor protection arrangements in OECD countries include:
 - the separation of the clearing guarantee function from the role of the fidelity fund
 - limiting protection to “small” investors (EU Directive)
 - industry-wide funds to provide cover to clients of participating financial services intermediaries including life insurance organisations and investment managers (the UK Investors Compensation Scheme)
 - maximum claim limits on all forms of claim against the fidelity fund
 - a requirement that the stockbroker be insolvent prior to a claim being paid
 - specific legislative arrangements for the insolvency of stockbroking firms.
- Part B of this submission identifies the current and future securities industry developments which may impact on SEGC risk and funding.
- Technology, product innovation and internationalisation of market activity will affect the risks to the Fund. Growth in risk to the Fund in the future may oustrip the growth in the Fund itself, and appropriate risk minimisation will play an important part in maintaining adequate levels of funding.

- SEGC relies on the quality of ASX regulation through Business Rules and clearing arrangements for the minimisation of risk to the Fund.
- Legislation contemplates that the NGF may provide cover to another “participating exchange” and if this eventuates, regulatory standards comparable to those of ASX should be required and the size of the Fund increased.
- The proposed new structure of the ASX is unlikely to materially affect the nature and extent of risk to the NGF provided the same standards of accreditation and compliance with Business Rules are maintained.

PART A

FACTUAL SUMMARY

1. INTRODUCTION

- 1.1 This paper is presented by Securities and Exchanges Guarantee Corporation Limited (SEGC), which administers the National Guarantee Fund (NGF) under Part 7.10 of the Corporations Law.
- 1.2 The NGF is part of the web of “investor protection” for participants in the Australian securities industry which is provided through the combined effect of:
- the Corporations Law in its regulation of companies, the exchange and members of the exchange;
 - ASC regulatory supervision;
 - regulation by the ASX;
 - stockbrokers’ own management practices;
 - recourse to the NGF.
- 1.3 The NGF scheme contributes to market confidence in the ASX by providing three significant forms of investor protection:
- A. a mechanism for ensuring clearing guarantee for ASX markets and contract completion guarantee for clients;
 - B. a mechanism for investors dealing through ASX member organisations (stockbrokers) to claim compensation for the default, fraud or insolvency of a stockbroker in the circumstances set out in the legislation; and
 - C. funding for significant systems development projects, through payments to the Securities Industry Development Account, which have had the effect of reducing transaction risk on the ASX.
- 1.4 The paper is presented in two parts. Part A responds to the Inquiry’s request for factual information regarding the financial system in Australia. It provides a summary of the operation of SEGC in its management of the NGF, and includes a comparison with international investor protection arrangements in the securities industry.
- 1.5 Part B of this submission identifies current and future developments in the Australian securities industry which may impact on SEGC risk and funding.

2. EVOLUTION OF INVESTOR PROTECTION FUNDS IN THE AUSTRALIAN SECURITIES INDUSTRY

(a) Developments since the Campbell Inquiry

- 2.1 The Campbell Inquiry observed that the financial system could not operate efficiently unless investors at large have confidence in the underlying solvency of financial institutions as a group and in the stability of the financial markets overall.¹
- 2.2 Prior to the formation of ASX, the six state stock exchanges were required to establish and maintain a fidelity fund to be applied for the purpose of compensating persons who suffer pecuniary loss by reason of a defalcation or fraudulent misuse of securities or documents of title to securities or of other property, by a member of the securities exchange or a partner of a member firm.²
- 2.3 When the ASX was formed in 1987, the fidelity funds of the six state exchanges were amalgamated to form the NGF, administered by SEGC.
- 2.4 The amalgamated Fund functions not only as a fidelity fund, but also provides a contract completion guarantee and is a source of funding for developments in the Australian Securities Industry.
- 2.5 Legislation governing the Fund has been amended to keep pace with developments initiated by the ASX, such as the introduction of fixed settlement and netting of market contracts (in 1991) and the introduction of CHES (in 1994).
- 2.6 SEGC is a non profit organisation and does not trade in its own right. It holds the assets of the National Guarantee Fund as trustee and administers the Fund for the purposes set out in Part 7.10 of the Corporations Law.
- 2.7 As at 30 June 1996, the Fund's net asset value was \$143 million.

(b) Current Investor Protection under Part 7.10 of the Corporations Law

- 2.8 In carrying out its statutory duties SEGC performs the dual roles of protecting the investor and protecting the integrity and efficiency of the market.
- 2.9 The circumstances in which a party may claim against the Fund are restricted to those situations set out in Part 7.10 of the Corporations Law.

¹ Final Report of the Committee of Inquiry into the Australian Financial System dated September 1981, para. 1.32.

² Under section 111(1) Securities Industry Act 1980 as amended.

- 2.10 Part 7.10 of the Corporations Law provides a right of recourse to the National Guarantee Fund by:
- A. providing a guarantee of contract completion for transactions in equity, debt and derivative securities in relation to companies which are listed on the ASX, such that:
 - a client may look to the NGF to ensure completion of any “reportable” sales and purchases of equity and debt securities which have not been completed within the time limit (Division 6);
 - a member stockbroker or the securities or derivatives clearing houses may look to the NGF to ensure completion of all netted transactions in those ASX markets (Division 6B); or
 - a lender under a “Guaranteed Securities Loan” may look to the NGF to ensure performance of a borrower’s obligations (Division 6A).
 - B. providing a fidelity fund upon which clients of member stockbrokers can claim compensation for loss resulting from:
 - the unauthorised transfer of marketable securities (Division 7);
 - a stockbroker wrongfully cancelling or failing to cancel a certificate of title to marketable securities (Division 7A); and
 - a stockbroker becoming insolvent and failing to meet its obligations to a client who had previously entrusted property to it in the course of the stockbroker’s business of dealing in securities (Division 8).
- 2.11 The combination of contract guarantee and fidelity fund protection provides a fully integrated approach to meeting a defaulting broker’s obligations and protecting the investor.
- 2.12 There are limits on the right to claim, including:
- A. time limits on all claims, with the SEGC Board having the discretion to extend time;
 - B. aggregate claims for property entrusted to a stockbroker under Division 8 are limited to \$9.8 million (14% of the current Minimum Amount) for any one insolvent stockbroker; and
 - C. no NGF protection for moneys lent to stockbrokers.
- 2.13 Under the present legislation, except in the case of Division 8, an aggrieved client is entitled to make a claim on the Fund prior to the stockbroker becoming insolvent. This provides an accessible remedy for investors who would not be financially able to initiate private litigation. The trade off is an increase in claims management work for SEGC even though the stockbroker in default may be in a healthy financial position.
- 2.14 Institutional investors have the same rights as private clients and may equally make a claim on the Fund prior to the stockbroker becoming insolvent. There is no limit on the size of transactions covered by Division 6, 7 and 7A, leaving the NGF open to large single claims.

2.15 Division 8 provides a catch-all protection whereby clients may be compensated for losses arising from a stockbroker becoming insolvent and failing to meet its obligations in relation to property entrusted to it in the course of the stockbroker's business of dealing in securities. "Property" is broadly defined in the legislation to include money, securities or scrip.³ However, this protection is limited to an aggregate amount of 14% of the minimum amount of the Fund.

(c) SEGC Relationship with the ASX and ASC

2.16 SEGC is a wholly owned subsidiary of ASX but operates independently of ASX in performing its statutory duties. The ASX is the sole member of SEGC and appoints three of the six directors. Those three directors nominate for appointment three other directors who are independent of ASX and member organisations of ASX.

2.17 ASX pays to SEGC interest earned on two-thirds of stockbroker trust accounts deposited with ASX.

2.18 If the minimum amount of the NGF falls below the required amount, ASX (which has the power to levy its members) and transactions on the ASX may be levied to restore the Fund to its minimum amount.

2.19 If the NGF has a surplus over the minimum amount, SEGC may pay money from the NGF to the Securities Industry Development Account which is operated by ASX.

2.20 SEGC staff are seconded from ASX and management fees in respect of SEGC administration, accounting and legal services are paid out of the National Guarantee Fund to ASX.

2.21 ASX sets and monitors the capital adequacy of stockbrokers. Because claims against the NGF generally arise as a result of stockbroker insolvency, ASX consults with SEGC in relation to market and regulatory developments which may affect the risk to the NGF.

2.22 Consistent with its responsibility to maintain the confidence of investors in securities markets by ensuring adequate protection, the ASC has some specific oversight responsibilities for SEGC, such as the approval of the appointment of fund managers. Additionally, the Business Rules of ASX and the Securities Clearing House are subject to review by the ASC and Department of Treasury.

3. PERFORMANCE OF THE NATIONAL GUARANTEE FUND

(a) Source of Funds

3.1 Upon amalgamation of the fidelity funds of the six State exchanges in 1987 the assets of these funds were transferred to the NGF. The total value of these funds was \$60,406,000. Sources of those assets included contributions by stockbrokers, interest on moneys invested by the state stock exchanges which were being held on trust for stockbrokers and earnings on investment of the state fidelity funds.

³ Section 920 of the Corporations Law.

- 3.2 The principal current sources of funds for the National Guarantee Fund are:
- earnings from investment of the Fund; and
 - interest earned on two-thirds of stockbrokers' trust accounts deposited with ASX as required by section 889 of the Corporations Law.
- 3.3 In addition, SEGC receives dividends from the liquidation of stockbroking entities in respect of which it has met claims.
- 3.4 SEGC may levy ASX and transactions on the ASX if the fund falls below the Minimum Amount. SEGC also has authority to take out insurance and to borrow as an additional source of funding.
- 3.5 Earnings on the assets of the NGF are income tax exempt.

(b) Claims History

- 3.6 The great majority of claims paid by SEGC arose following the insolvency of seven stockbrokers in the years immediately following the 1987 market crash.
- 3.7 The total value of all claims paid to 30 June 1996 is \$21 million, of which \$12.5 million was recovered by SEGC during liquidation of the stockbrokers.
- 3.8 SEGC has also facilitated settlement of outstanding transactions between clients and the liquidators/receivers of defaulting brokers to the value of \$8.8 million.
- 3.9 Primary causes of stockbroker insolvency leading to claims include losses on principal trading, poor procedures, poor financial management, inappropriate trust accounting and misuse of client property.
- 3.10 In its recent review of the risk to the Fund (see section 4 for details), Tillinghast Towers Perrin concluded that the NGF "is basically underwriting the quality of management in the stockbrokers."⁴
- 3.11 A contributing factor to the low level of claim activity is the quality of regulatory control over broking firms provided by the ASX and ASC. SEGC relies on this regulatory control to mitigate market risks, since the reduction of risk to the Fund is a corollary of reduced risk in the market. Other contributing factors to the reduction of claims include improvements to the settlement system and improvements in the capital position of stockbrokers.⁵

⁴ Report on the Risk Exposure of the National Guarantee Fund, Tillinghast Towers Perrin, 12 February 1996, page 53.

⁵ Tillinghast Towers Perrin, Report on the Risk Exposure of the National Guarantee Fund, 12 February 1996, page 47.

(c) Management of the Fund's Assets

- 3.12 The legislation provides that the Fund may be invested in a “permitted manner”.
- 3.13 The Board’s strategy in managing the Fund is to achieve the best return for the Fund consistent with the protection of the Fund’s assets. Professional investment managers are appointed by the SEGC Board with the approval of the ASC.

(d) Development Funding through SIDA

- 3.14 SEGC has a discretion to make payments to the Securities Industry Development Account (SIDA) where the amount of the National Guarantee Fund exceeds the Minimum Amount (which is currently \$70 million). SIDA is operated by ASX.
- 3.15 Payments from SIDA are made only for “permitted purposes”. A permitted purpose is a purpose that has been approved by the Minister as relating to the development of the securities industry in Australia or a “prescribed purpose”⁶.
- 3.16 To date, \$56.3 million has been paid from the NGF to SIDA for six projects aimed at improving trading and settlement systems and associated information systems.
- 3.17 Consistent with SEGC’s role, these projects have contributed to improving market efficiency and reducing market risk.
- 3.18 Recently, the most significant payments to SIDA have been made for funding the development of CHES (Clearing House Electronic Subregister System). CHES provides:
- electronic transfer and registration of quoted securities (Phase I, implemented in 1994);
 - settlement of market transactions in cleared funds (Phase II, the Delivery versus Payment phase, implemented progressively between April and August 1996); and
 - the capacity to achieve T+3 settlement in the future.
- 3.19 The Board of SEGC has approved in principle future payments from the Fund to SIDA for the purpose of the development of ASX’s New Trading Platform and the automation of ASX Derivatives Trading.

4. RISK ASSESSMENT FOR THE NGF

- 4.1 The Board of SEGC monitors risk to the Fund and is responsible for determining the Minimum Amount to be held in the Fund. In doing this, the Board has regard to existing capital adequacy standards, market developments and stockbroker exposures to markets and clients. The Board may seek specific actuarial advice on new products and other specific risk areas.

⁶ Section 945 of the Corporations Law.

- 4.2 In its most recent review of the Minimum Amount, the Board was assisted by the actuarial firm of Tillinghast Towers Perrin. The current minimum amount is \$70 million, which is comprised of:
- a Maximum Probable Loss estimation of \$50 million; and
 - an additional \$20 million to cover timing delays between payments made out of the NGF and recoveries received.
- 4.3 In assessing the Maximum Probable Loss, factors including the following were taken into account:
- growth in market turnover in equities and derivatives;
 - actual stockbroker positions and client exposures;
 - a share market crash similar to that of October 1987, extrapolated to the current day environment;
 - the potential impact of such scenarios as:
 1. a rogue trader who circumvents their organisation's risk management procedures;
 2. large principal trading loss;
 3. failure to identify a position which would result in losses exceeding the stockbroker's capital in the event of adverse market movements;
 4. misappropriation from a stockbroker's trust account or from a custodial holding;
 5. "skimming" ie. charging or paying the client a slightly different price from that actually paid or received;
 6. fraudulent transfer, particularly through electronic transfer systems; and
 7. unsuccessful underwriting by a stockbroker of a large issue, where the stockbroker must take unwanted stock.
- 4.4 In its report to the Board of SEGC, Tillinghast acknowledged that implementation by ASX of improvements in equity settlement systems, (namely trade netting, T+5 settlement and delivery versus payment settlement⁷), substantially reduces the risk of claims against the Fund. Improvements in the capital positions and management of stockbroking business were also noted.
- 4.5 SEGC is satisfied that the current minimum amount of the Fund provides appropriate cover to meet its obligations under Part 7.10 of the Corporations Law. Nevertheless, in addition to the statutory minimum amount, SEGC has an objective of maintaining at least \$100 million in the Fund, after taking into consideration any conditional commitments to SIDA which may be met in the future.

⁷ Tillinghast Towers Perrin, Report on the Risk Exposure of the National Guarantee Fund, 12 February 1996, page 31.

5. INVESTOR PROTECTION IN OTHER OECD COUNTRIES

(a) International Investor Protection Arrangements

5.1 Investor protection arrangements in other jurisdictions vary considerably. Most funds separate clearing guarantee and fidelity fund arrangements, and this part of the paper compares key areas in fidelity schemes operating in OECD countries.

Who is protected

5.2 The OECD standard is to provide a compensation fund specifically for clients of stock exchange members. In Australia, the NGF also provides compensation to brokers and clearing houses as part of its contract completion and clearing guarantee roles. In the UK the Investors Compensation Scheme covers the activities of not only stockbrokers but also of “participating” investment managers, including unit trust organisations, life insurance companies and other financial intermediaries.

5.3 The European Community’s Investor Compensation Directive prescribes a minimum level of protection to “small investors” which are defined as excluding institutional investors, superannuation, government and central authorities.

Sources of funds

5.4 Most fidelity funds receive contributions from firms as they are admitted to the exchange, augmented by regular contributions from member firms on an annual basis (for example as a percentage of the firm’s revenue).

5.5 A number of funds have reached critical mass in terms of assets but provision has been made for levies in the future should the fund falls below a minimum amount, as is the case in Australia. Since its inception the NGF has had no requirement to increase its funds under management by recourse to ASX or member firms.

5.6 A number of fund trustees, including SEGC, have the ability to acquire insurance against and/or to borrow in the event of a claim burden in excess of the fund’s assets. In the case of the Korean Joint Compensation Fund, the Korean Stock Exchange itself will make up any shortfall. The UK Investors Compensation Scheme does not have a fund but relies on borrowings and levies raised on an as needs basis (although this is currently under review).

Types of Protection

5.7 Most OECD countries separate clearing guarantee arrangements from the fidelity fund, and do not provide a contract completion guarantee. The inclusion of the contract completion guarantee in the protection offered by the NGF is peculiar to the Australian environment, but provides an effective integrated system of protection across ASX markets for participants in those markets.

5.8 In general, most funds provide protection to clients for losses arising from transactions only in the case of bankruptcy or fraud on the part of the member firm. The US SIPC Fund and the European Community Investor Compensation Directive only protect investors in the event of insolvency of the stockbroker firm and do not cover fraud. The Japanese and Korean schemes do not cover claims arising out of the insolvency of a member firm (leaving investors to pursue their claim for entrusted property in insolvency and trust law).

- 5.9 Only in Australia is an aggrieved client permitted to receive compensation from the Fund prior to the stockbroker becoming insolvent. In some jurisdictions, the stockbroker must be technically insolvent prior to the claim being paid. In some jurisdictions, because of the potential implications for the financial system, the insolvency of a stockbroking business is governed by specific legislation, for example, to protect the position of clients in the liquidation and to recognise clearing house arrangements that provide for net settlements.
- 5.10 Most funds provide protection for moneys on deposit for the purpose of purchasing securities but not for moneys held on deposit for the purpose of earning interest income.

Level of Protection

- 5.11 All of the funds compared have maximum claim limits on fidelity fund claims, with the exception of the NGF which has no maximum limit on claims relating to contract completion default, unauthorised transfer of securities or wrongful cancellation of certificates of title to securities (Divisions 6, 7 and 7A respectively).
- 5.12 Broking firms in the US have expanded their investor protection arrangements (often to achieve competitive advantage) by taking out their own insurance cover for claims in excess of the SIPC Fund cover.

(b) Comparison Matrix

- 5.13 Attachment 1 of this paper compares the fidelity fund arrangements in place in the main securities exchanges of the following OECD countries:
- Australia
 - Canada
 - France
 - Hong Kong
 - Japan
 - Korea
 - New Zealand
 - Philippines
 - Singapore
 - United Kingdom
 - United States

The matrix compares 4 key areas for each scheme:

1. the funding or contribution regime
2. the parties protected under the scheme
3. the events covered by the scheme
4. the securities covered by the scheme
5. the Fund value as a percentage of market capitalisation

(c) Recent Developments

IOSCO Technical Committee on Client Asset Protection

5.14 The issue of the protection of client assets from the risk of misappropriation and insolvency is currently under scrutiny at an international level by a working party of the International Organisation of Securities Commissions (IOSCO).

5.15 In the most recent draft of its paper⁸ IOSCO Working Party 3 made recommendations on minimum standards of investor protection in financial markets, placing significant emphasis on default prevention rather than reliance on protection funds. The IOSCO paper recommends that regulatory bodies implement structures for preventing client losses such as⁹:

- ensuring that firms implement strong internal controls for safeguarding client assets; and
- appropriately extensive supervision of firms.

5.16 The IOSCO paper explores different types of protection available to clients of insolvent firms such as¹⁰:

- preservation of assets in insolvency, through either separation of client assets from firm assets or preferential creditor status; and
- compensation arrangements such as fidelity fund schemes or mandatory firm insurance.

5.17 The arrangements currently in place in Australia for regulating the relationship between ASX member firms and their clients are consistent with the general principles set out in the IOSCO draft paper.

The European Community Directive

5.18 After a lengthy consultation process, the EU has issued an Investor Compensation Directive (ICD) which sets minimum requirements for investor protection schemes to be maintained by member states.

⁸ IOSCO Working Party 3, Paper to Technical Committee on Client Asset Protection, Draft VIII, dated 5/7/96.

⁹ IOSCO Working Party 3, Paper to Technical Committee on Client Asset Protection, Draft VIII, dated 5/7/96, Recommendation 11, page 9-10.

¹⁰ IOSCO Working Party 3, Paper to Technical Committee on Client Asset Protection, Draft VIII, dated 5/7/96, Recommendation 11, page 10-16.

- 5.19 The ICD requires a harmonised minimum level of protection at least for smaller investors in the event of an investment firm being unable to meet its obligations. A number of European countries have commenced implementation of arrangements consistent with the ICD, and those arrangements are expected to exceed the minimum requirements.

PART B

SEGC ROLE IN CURRENT AND FUTURE INDUSTRY DEVELOPMENTS

6. EXPANSION OF RISK UNDERWRITTEN BY THE FUND

(a) SEGC's Current Role

- 6.1 The NGF tripartite role of providing clearing guarantee, client contract guarantee and fidelity protection offers a single seamless protection across the integrated markets of the ASX in the event of market default.
- 6.2 The first form of protection is essential to market integrity and stability. A full clearing guarantee for ASX securities and derivatives markets ensures that funds are available to complete market transactions by meeting the obligations of a defaulting stockbroker and thereby protecting counterparties (and their clients). This is essential to prevent or minimise the knock-on effect in the market of a stockbroker default.
- 6.3 The second and third forms of protection, client contract guarantee and fidelity protection, promote confidence in investing in the ASX market and in dealing with stockbroker members. This role is particularly important to the "small" investor who does not have the sophistication or resources of the institutional investor to assess counterparty risk.
- 6.4 As noted in section 4, SEGC is satisfied that its current funding levels are sufficient to meet obligations it may be called on to meet under Part 7.10. However, the pace of change in the industry may see the growth in risk in the future outstrip the growth of the Fund itself. Appropriate risk minimisation will play an important part in maintaining adequate funding levels.

(b) Growth in ASX Market Activity

- 6.5 Technology, product innovation and the internationalisation of the securities industry will affect the risks in the financial sector which are underwritten by the NGF. Although the actual impact of these developments must be analysed on a case by case basis, it seems likely that there there will continue to be an expansion in the level of risk covered by the Fund commensurate with the growth in ASX market capitalisation and turnover and new products.

(c) Expansion of Stockbroker Activities

- 6.6 ASX member organisations are becoming increasingly involved in non-traditional stockbroking areas such as managed funds and may be expected to participate in proprietary networks for trading in securities not listed on ASX.
- 6.9 The legislation does not provide any contract completion guarantee for transactions that are not in ASX quoted securities entered on ASX markets or reported to ASX. This is appropriate as ASX does not specifically regulate such activity, and because SEGC has no means of assuring itself that appropriate risk minimisation measures are in place and cannot assess the extent of risk to the Fund.

- 6.10 If the "non traditional" activity is nevertheless in the course of the stockbroker's business of dealing in securities, clients may be entitled to the "property entrusted" protection under Division 8, if the stockbroker became insolvent. This protection is capped at 14% of the Minimum Amount of the Fund for any one insolvency.
- 6.11 If in the future it were proposed that the NGF should be expanded to cover "non-traditional" activities, the implications for risk assessment and funding would require careful assessment.
- (d) A New Exchange as a Participating Exchange of SEGC**
- 6.12 SEGC's risk could be dramatically increased if the NGF covered the member organisations of more than one Exchange. This is discussed below.

7. THE SIGNIFICANCE OF REGULATION

(a) SEGC Dependence on Regulatory Quality

- 7.1 Because SEGC does not have (and does not seek) a regulatory role, it relies on quality regulation by other bodies for the minimisation of risk to the Fund. This is provided by the ASC and ASX. The Business Rules of ASX and the Securities Clearing House (SCH) are central to the regulation of capital adequacy, protection of client assets and net settlement. Given SEGC's dependence on those standards, it is necessary that SEGC has the ability to satisfy itself of their adequacy and to refer any concerns that it may have to the ASC and Government.
- 7.2 Although there is no formal requirement of consultation, this exists in practice between ASX, SCH and SEGC, since these bodies all have a common interest in maintaining the Fund. ASX and SCH keep SEGC informed of developments and consult with SEGC in areas that affect the risk to the Fund.

(b) Proposed New Structure of ASX

- 7.3 ASX intends to put a proposal to its members in October this year to change the structure of the ASX from a not-for-profit company limited by guarantee to a company limited by shares. If the proposal is adopted, membership of ASX will be separated from the right of access to ASX markets. It is proposed that all participants granted access would continue to be subject to the same standards of accreditation and the same requirements to comply with the Business Rules of ASX and the Securities Clearing House as currently apply to member organisations of ASX.
- 7.4 On the basis that the standards of market integrity will be maintained if the proposal is implemented, it is unlikely that there would be a material change to the nature or extent of risk to the NGF.

(c) A New Exchange as a Participating Exchange of SEGC

- 7.5 The relationship between risk, regulation and NGF cover is recognised in the legislative scheme which sets out that cover is only available in relation to the activities of stockbroker members of a “participating exchange”. To date, ASX has been the only participating exchange. The primary source of the Fund’s assets may be attributed to dealings on the markets of ASX (and its predecessors, the State stock exchanges) by stockbroker members and their clients.
- 7.6 The NGF legislation contemplates that cover may be extended to other “participating exchanges”. Such eligible exchanges are only those which meet the regulatory standards approved by the Minister under sections 769 and 770 of the Corporations Law.
- 7.7 The Articles of Association of SEGC provide that, as qualification for membership, the capital adequacy business rules of an exchange must be satisfactory and the exchange must implement adequate surveillance and enforcement measures to ensure compliance with those rules.
- 7.8 Because a new participating exchange would be likely to possess different product risk profiles with different methods of operation and self regulation, it would represent an entirely new area of risk to the NGF. SEGC would need to assess all relevant factors to ensure that satisfactory business rules were in place and that there was an appropriate level of funding.

Attachment 1. Comparison Matrix of International Investor Protection Funds

Country and Fund	Source of funds Percentage of Market Capitalisation	Parties covered	Events covered	Securities covered
Australia National Guarantee Fund (NGF)	<p>1. Assets acquired in 1987 on consolidation of state exchanges' funds have not required augmentation to date.</p> <p>2. Member firms can be called on when fund falls below minimum amount.</p> <p>3. Interest on two thirds of broker trust accounts deposited with ASX</p> <p>Fund Value: A\$143 million % of Market Capitalisation: 0.042%</p>	<p>1. Clients of stock exchange member firms</p> <p>Note: Stock exchange member firms and the stock exchange clearing houses are also covered under clearing guarantees.</p>	<p>1. Guarantees contract completion of reportable transactions in ASX quoted securities</p> <p>2. Compensation for loss arising from:</p> <p>a) unauthorised transfer</p> <p>b) wrongful cancellation of certificates of title</p> <p>c) insolvency of broker to whom client has entrusted property</p> <p>Note: Claims for loss from 1) and 2a) and 2b) can be made whilst broker still solvent.</p>	<ul style="list-style-type: none"> - ASX quoted equities - ASX quoted corporate debt securities - contract guarantee applies to ASX equity options
Canada Canadian Investors Protection Fund	<p>Member firms contribute:</p> <p>1. Regular annual contribution of 0.1875 % of firm's total annual revenue, minimum C\$5,000 pa.</p> <p>2. Member firms with capital deficiency have to pay a risk premium.</p> <p>3. Special assessments when required to a maximum of 1% of firm's revenue</p> <p>Fund Value: C\$75 million % of Market Capitalisation: 0.005%</p>	<p>Clients of member firms of 5 self-regulatory sponsoring organisations:</p> <p>The Toronto Stock Exchange</p> <p>The Montreal Stock Exchange</p> <p>Vancouver Stock Exchange</p> <p>Alberta Stock Exchange</p> <p>Investment Dealers Association of Canada.</p>	<p>Compensation for loss of securities and cash balances arising from the insolvency of members.</p>	<p>Protection applies in respect of:</p> <ol style="list-style-type: none"> 1. securities received, acquired, borrowed or held for safe keeping 2. cash balances including Moneys kept on deposit as cash, margin calls, foreign currency <p>“Securities” includes equities, options and futures traded on the 5 sponsoring stock exchanges</p>
France Guarantee Fund	<p>Legislation introduced into French law by the Law of 2 July 1996 and currently under implementation.</p> <p>Fund Value: No fund assets yet</p>	<p>Clients of all brokers on financial markets who are “small investors”, a categorisation which excludes institutional investors, superannuation, government and central authorities.</p>	<p>In the case of bankruptcy, the funds indemnifies clients following distribution, but only to a limited amount.</p>	<p>All financial market “securities” and “debts”.</p>

Country and Fund	Source of funds Percentage of Market Capitalisation	Parties covered	Events covered	Securities covered
<p>Hong Kong Unified Exchange Compensation Fund</p>	<p>Member firms:</p> <ol style="list-style-type: none"> 1. Contribute HK\$50,000 per share in the Exchange upon admission 2. May be required to replenish payments made to claimants <p>Fund Value: HK\$422 million % of Market Capitalisation: 0.016%</p>	<p>Clients of stock exchange member firms.</p>	<p>Compensation for pecuniary loss arising from a failure on the part of an exchange member to perform a legal obligation which arises because of:</p> <ol style="list-style-type: none"> a) bankruptcy, winding up or insolvency, b) breach of trust, c) defalcation, d) fraud, or e) misfeasance <p>on the part of an exchange member in connection with trading on the exchange</p>	<p>Does not cover futures (there is a separate fund for futures)</p>
<p>Japan TSE Liquidation Fund and Default Compensation Reserve</p>	<ol style="list-style-type: none"> 1. The TSE Liquidation Fund is constituted by the contributions of members upon entry to the exchange. 2. The Default Compensation Reserve is funded by the regular contributions of members made on a prorated trading volume basis. <p>Fund Value: ¥16,049 million % of Market Capitalisation: 0.005%</p>	<p>Clients of member firms of the Tokyo Stock Exchange</p>	<p>The Default Compensation Reserve provides compensation for loss arising from default by a member firm.</p> <p>Insolvency is not covered (reliant upon general insolvency law).</p> <p>Note that JASDEC (the clearing house) does not guarantee settlement.</p> <p>The TSE Liquidation Fund is the clearing fund.</p>	<p>All securities traded on the Tokyo Stock Exchange - equities, bonds, bond futures, options, convertible bonds</p>

Country and Fund	Source of funds Percentage of Market Capitalisation	Parties covered	Events covered	Securities covered
<p>Korea Joint Compensation Fund</p>	<p>1. Members contribute to the fund each time they trade securities: Bonds - 0% of trading value Stocks, beneficial certificates, warrants -0.001% of trading value Futures - 0.00015% of trading value 2. The Korean Stock Exchange itself will make up any shortfall on claims. Fund Value: US\$52 million % of Market Capitalisation: 0.000104249%</p>	<p>Clients of member firms of the Korean Stock Exchange</p>	<p>Guarantee of contract completion only, therefore compensation only available for loss arising from settlement default by a member firm. Insolvency and fraud are not covered by the fund.</p>	<p>All securities traded on the KSE - bonds, stocks, beneficial certificates, warrants, futures</p>
<p>New Zealand New Zealand Stock Exchange Fidelity Guarantee Fund</p>	<p>Members can be levied, as required, by the Board of the Exchange up to \$1 million in any one year. Fund Value: NZ\$251,000 % of Market Capitalisation: 0.0005%</p>	<p>Clients of stock exchange member firms</p>	<p>Compensation for loss arising from a sharebroking transaction as a result of a member firm being unable to meet its financial obligations (regardless of whether a result of fraud or mismanagement)</p>	<p>Covers shares, bonds and options listed on the exchange.</p>
<p>Philippines Securities Investors Protection Inc (SIPF)</p>	<p>Member firms: 1. Contribute P10,000 upon admission to the Exchange 2. Pay monthly dues of 0.002% of gross volume of transactions Fund Value: P38 million % of Market Capitalisation: 0.002%</p>	<p>Clients of member broker/dealers of the Philippines Stock Exchange and the Manila International Futures Exchange</p>	<p>Compensation for losses in the event of failure, insolvency or fraud of member brokers</p>	<p>Equities, debt, futures</p>

Country and Fund	Source of funds Percentage of Market Capitalisation	Parties covered	Events covered	Securities covered
<p>Singapore Fidelity Fund</p>	<p>1. Stock Exchange of Singapore contributes 10% of net income annually 2. Member firms required to contribute when fund falls below S\$5 million, to a maximum of S\$300,000 Fund Value: S\$9 million % of Market Capitalisation: 0.003%</p>	<p>Clients of stock exchange member firms</p>	<p>Compensation for pecuniary loss arising from defalcation of a member firm. Does not cover insolvency.</p>	<p>Equities but not futures</p>
<p>United Kingdom Investors Compensation Scheme</p>	<p>No fund assets. The scheme raises a levy in arrears from all firms covered by the scheme.</p>	<p>Clients of authorised firms participating in the scheme ie. the member firms of 5 self regulating organisations: 1. The Securities and Futures Authority 2. Investment Management Regulatory Organisation 3. Financial Intermediaries, Managers and Brokers Regulatory Association 4. Life Assurance and Unit Trust Regulatory Organisation 5. Personal Investment Authority</p>	<p>Provides compensation to clients only after failure of the participant and where the firm is unable to pay investors in full or within a reasonable time</p>	<p>All forms of securities (including life policies and units in trusts) provided the broker is a participant in the scheme</p>

Country and Fund	Source of funds Percentage of Market Capitalisation	Parties covered	Events covered	Securities covered
<p>United States Securities Investor Protection Corporation (SIPC) Fund</p>	<p>Member firms:</p> <ol style="list-style-type: none"> 1. Contribute 0.00095% of net operating revenues per annum, minimum of US\$150 2. SIPC can raise an additional levy of up to 1% of members' gross revenues in any 12 month period provided it will not adversely affect the member's financial condition <p>Fund Value: US\$850 million</p> <p>% of Market Capitalisation: less than 0.01% (covers all US Stock Exchanges eg NYSE, American, local exchanges)</p>	<p>Clients of SIPC member firms include with some exceptions all persons registered as brokers or dealers under the Securities Exchange Act and all members of a national securities exchange.</p>	<p>Protects against broker insolvency (not fraud) Doesn't guarantee contract completion</p>	<p>Equities, debt, some on market derivatives but not futures</p>