Submission to

Council of Financial Regulators

Review of Financial Market Infrastructure Regulation

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ABOUT CHOICE

CHOICE exists to unlock the power of consumers. Our vision is for Australians to be the most savvy and active consumers in the world.

As a social enterprise we do this by providing clear information, advice and support on consumer goods and services; by taking action with consumers against bad practice wherever it may exist; and by fearlessly speaking out to promote consumers' interests – ensuring the consumer voice is heard clearly, loudly and cogently in corporations and in governments.

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Council of Financial Regulators
Review of Financial Market Infrastructure Regulation

CHOICE wishes to comment in relation to Part 11 of the consultation paper: Compensation fund arrangements for securities markets.

We have long standing concerns with the operation, governance and scope of the National Guarantee Fund.

Amongst our concerns are that:

- The fund is not managed in a transparent way.
- The fund is virtually unknown by investors, including those who may need access to it.
- The fund has substantial excess funds which could and should be used for investor focused purposes – but they are not.
- We are not aware of any review of the heads of claim since inception of the scheme. The failure to pay any claims arising out of recent collapses suggests the scheme in need of review.
- The proposed sale of the ASX to the Singapore stock exchange raised questions as to the fate of the control of the NGF and $110 million of Australian's money.
- The arrival of new market operators raises the possibility of different consumer protections applying depending on where a trade was executed.
- We question whether ASX ownership and control of the NGF is appropriate in the modern market place.

What should be done

Our preferred solution is that the NGF is separated out from the ASX and set up as a company limited by guarantee.

Principally, we think **the scheme should be independent**. It should be separated out from the ASX and set up as an **independent company** limited by guarantee and governed by an **independent Board**. The NGF should operate as an independent whole-of-market compensation scheme, to cover trades through all market operators, not just the ASX as it currently stands.

The new independent NGF company should accept new market operators as its members providing whole of market coverage and protection for consumers. Brokers and consumers will execute trades through all market operators and the same protections should apply across the market.

NGF funds are effectively consumer funds and should therefore be applied for maximum consumer benefit. The NGF corpus was built up by payments from the interest on stockbrokers trust accounts. As a group the same consumers who built the NGF corpus will also utilize the services of new market participants.

The Board of the new financial markets compensation scheme should follow the model adopted by the Financial Ombudsman scheme. That is, it should comprise of an equal number of directors with industry and consumer/investor protection expertise headed by an independent Chair. Collectively however the Board should have the skills it needs to execute effective governance.

It would be appropriate for ASIC to appoint the first Board. Thereafter the Board could follow the good governance principles set by the ASX and successfully applied by the Financial Ombudsman.

The Board should be charged with a review of the two most pressing problems: the inadequacy of the heads of claim for the fund; and, the processes for the distribution of the excess funds.

Background

The Securities Exchanges Guarantee Corporation (SEGC) is the trustee for the National Guarantee Fund, which compensates stock market investors for certain losses.

These include:

- failure to account for purchased securities or proceeds of a sale;
- losses that result from unauthorised transactions;
- losses from a cancellation or failure to cancel a certificate of title contrary to the operating rules; and
- losses if the dealer becomes insolvent and fails to meet its obligations.

The NGF was formed in 1987 when the assets of the fidelity funds of the state exchanges were merged and a national exchange began operating as the ASX. It had then two functions: investor compensation; and, trades clearing and settlement support.

It started with a pool of $60.4 million which had risen to nearly $165 million in 2005. That year the fund was split in half. Responsibility for clearing and settlement functions and $71.5 million were transferred to the Australian

Clearing House (ACH), a wholly owned subsidiary of the ASX (monitored by ASIC).

As at 20 June 2010 net assets in the NGF were at $110 million (compared to $105 million at 30 June 2009).

Until 2004 income was derived from both investment of the pool and from interest on participant's trust funds, however this was phased out in 2004 as part of the Financial Services Reform (FSR) transition. Trust account interest now goes to a separate account which can be apportioned on approval of the Minister on a needs basis to either the NGF, for industry development purposes for public (not commercial) benefit or to a pooled insurance scheme as part of the new compensation arrangements. We have been unable to find out who controls this account, or even its name.

The SEGC sets "minimum amounts" to ensure the fund remains viable. The current minimum is $76 million set on 31 March 2005 prior to the split.

Financial Industry Development Account
The Corporations Act allows the SEGC to pay at its discretion any amount above the minimum to the Financial Industry Development Account (FIDA). Since 1988 nearly $136 million has been paid to FIDA.

Money in FIDA can only be used for programs that develop the financial industry primarily for a public benefit, not to promote profitability of the ASX. The Minister approves expenditures.

Over the last 20 years we understand about $20 million has been spent on ASX investor education projects, although we have no knowledge about the details or effectiveness of these projects.

The remaining $110 million has been spent on initiatives that develop the ASX such as the Clearing House ($30m), automated trading systems ($30m+), data management systems and smaller projects such as the ASX's website. While all of these may indirectly benefit consumers they substantially benefit the ASX.

Governance
The SEGC Board is currently made up of directors experienced in matters involving the securities and funds management industry. This needs to be balanced with directors experienced in compensation schemes, investor protection and general public interest needs.

Claims
From 1988 to 1991 over 5000 claims were received in respect of seven insolvencies. Since 1992 the NGF has received very few claims – barely 200 and

only 31 since 2001. There is now almost no awareness of the existence of the scheme.

However the SEGC 2010 annual report notes that it did receive a "significant number of claims" following a spate of recent collapses (Opes Prime etc). Unlike previous years, little information has been provided about claims since 2008 including data on the number of claims received. However we do know all have been denied. This suggests the scheme is unresponsive to current consumer needs.

Since 1988 $21.65 million has been paid to investors and $13.43 million has been recovered by the NGF from stock brokers. Three quarters of payments have been for less than $20,000. Since 1995 four claims of $50K or more have been paid. In 2002/03 a global settlement of $300K was made for 129 investors. Excluding the early collapses, most claims (over 75%) relate to unauthorised transfers.

Investors whose claims are denied by the NGF may appeal via the courts within three months of the decision. Investors have taken the SECG to court at least ten times.

ASX competitors

CHI X does not have a compensation fund. It seems CHI X intends to meet it's s912(b) Corps Law obligations through indemnity insurance, which has a range of well documented inadequacies as a consumer compensation mechanism, not least because it is a policy to protect Chi X and not consumers.

It is our view that funds held in the NGF are client funds. They were amassed from interest on stockbrokers trust accounts, money that is rightly consumers' money. Since 2004 the fund has been self-perpetuating.

It is also our view that the investor using Chi X (and any other possible market entrant) will also be those investors trading through the ASX. Therefore we support separating the NGF and SEGC from the ASX into an independent whole of market markets related compensation scheme.

In the process, the terms of reference of the NGF should be reviewed to ensure they are consistent with the modern market place.

The Board should be reconfigured with an independent chair and equal number of directors with investor protection expertise based on the successful governance model of a number of industry based Ombudsman including the Financial Ombudsman.

Issues

1. No-one knows about the fund. It is not clear how people who need the fund find out about its existence.

2. The scheme has not paid one claim in respect of the Opes Prime collapse suggesting its terms of reference are of date.

3. There is little transparency and no consumer/public interest input into how FIDA funds, and the monies in the post-FSR account that receives the trust account interest, are administered or spent.

4. Many of these issues could be addressed if the SECG Board was to include directors with experience in investor/consumer protection issues and the operation of compensation schemes. We have argued in the past that the financial services external dispute resolution schemes governance arrangements could usefully be replicated at the SEGC. At the very least organisations such as CHOICE and shareholder and investor organisations should be given the chance to nominate directors.

5. Taken together the above points indicate the scheme is in need of an independent review. This should be overseen by ASIC.

6. The scheme needs to be separated from the ASX, to cover all market operators and its terms of reference need to be modernised.