31 October 2016

Chair
Securities Exchanges Guarantee Corporation
Level 6 20 Bridge St
Sydney NSW 2000

By e-mail: segc@asx.com.au

Dear Ms Milne

National Guarantee Fund Reform Proposal

The Australian Financial Markets Association (AFMA) appreciates the opportunity to comment on the Securities Exchanges Guarantee Corporation's (SEGC) proposal to reform the National Guarantee Fund (NGF).

AFMA agrees with the central proposition put forward by the SEGC that the heads of claim for the NGF and broader market licensee compensation claim provisions in Part 7.5 of the *Corporations Act* do need to be updated and rationalised. Generally, there should be a common heads of claim provision to provide for protection in the event of a failure of a trading or clearing participant.

AFMA considers that broader public policy questions will arise from this proposal by the SEGC which looks at the question of the heads of claim purely from the perspective of the sustainability of the NGF. AFMA has long maintained the importance of retaining the NGF as an independent compensation arrangement. AFMA supports the continuation of the NGF as compensation fund relating to the cash equities market, of which any market licensee operating such a market can become a member.

It is noted the SEGC has flagged wider reform issues including the extent of coverage and membership which are likely to be raised if the heads of claim amendment to the law was to proceed. In the present environment where external dispute resolution and financial advice compensation arrangements are once again under policy review, AFMA believes that legislative amendments to enable reform of the

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NGF should not be conflated into the wider reform debate over the future of external dispute resolution because of the quite distinctive purpose of securing contract certainty which market licensee compensation regimes provide.

1. Context

At its origin in 1986 the NGF was intended to provide for contract guarantee and insolvency protection. The no-fault contract guarantee was intended to ensure that where a party to a securities transaction does not complete its obligations, those obligations would be met by the NGF. This no-fault system of contract guarantees contrasted with claims against earlier stock exchange fidelity funds under the provisions of the old Part IX of the Securities Industry Act 1980 where defalcation or fraudulent misuse of property was required to establish a claim. Direct access to the NGF for compensation in respect of a dealer insolvency also allowed for easier access than previous fidelity fund provisions which allowed for compensation through formal Bankruptcy Act mechanisms.[1] The two initial grounds for claiming against the NGF were subsequently supplemented by adding unauthorised transfer of securities; and contravention by a stockbroker of the certificate cancellation provisions. This has resulted in the present day Division 4 compensation arrangements which cover incomplete securities transactions (subdivision 4.3); unauthorised transfers of securities (subdivision 4.7); cancellation of certificates of title (subdivision 4.8); and insolvent participants (subdivision 4.9).

2. Heads of claim

The concept of bringing together the distinctive heads of claim in Division 3 (section 885C and 885D) and Division 4 (section 888A and subordinate regulations) into a common form is supported. The distinction arises from the evolution of the NGF described above and it is hard to see a public policy justification for different heads of claim depending on the nature of the products traded on a market. While this is a simple proposition, amending the law in the context of the sharp distinctions between Divisions 3 and 4 does raise some drafting issues. For example, would sections 885C and 885D be amended with a cross reference from section 888A to apply the heads of claim to the Division 4 NGF compensation?

With regard to the changes to existing heads of claim, the first point AFMA wants to emphasise in agreement with the SEGC is that it is completely at odds with the purpose of the NGF for compensation for trading losses to be considered as a head of claim. Trading losses have never been included and should continue to be definitely excluded.

It is noted the proposal intends to limit the revised head of claim to insolvency only. This would mean that the current incomplete securities transactions (subdivision 4.3); unauthorised transfers of securities (subdivision 4.7) would fall away. These two heads equate to the Division 3 compensation arrangements, which apply to all current market licensees (including ASX in limited circumstances) and which, broadly speaking, are available to meet certain claims arising from fraud or defalcation of money or other property by a participant of that market. This illustrates the general point made at the start that a proposal to rationalise and combine the heads of claim is much more than a simple change to the Division 4 regulations.

[1] The Hon Lionel Bowen MP, Second reading speech on 18 February 1987 for the Australian Stock Exchange and National Guarantee Fund Act 1987

With regard to the restriction of claims to insolvency alone, AFMA notes the citation of the Canadian Investor Protection Fund (CIPF) as a model as it appears to contemplate that fraud or defalcation are among the bases for proof of claim in the sense that the CIPF covers claims resulting from insolvency involving 'unlawfully converted property'. It is AFMA's understanding that the CIPF covers customers of fund members who have suffered or may suffer financial loss solely as a result of the insolvency of a fund member. Such loss must be in respect of a claim for the failure of the fund member to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds or other property received, acquired or held by, or in the control of, the fund member for the customer, including property unlawfully converted.

To be clear, it is AFMA's position that it should continue to be possible to make a claim purely based on the fact of an event of insolvency without having to establish ancillary grounds of fraud or defalcation. The policy question is whether these should remain as additional separate grounds for claim.

AFMA considers that further policy consultation by the Government, if it accepts the general proposition on the need for reform, will be needed on whether insolvency should be the sole and sufficient head of claim.

3. Cap on claims

AFMA supports introducing the cap on claims of $1 million and a sub-limit of $250,000 with respect to cash.

If you have any queries with regard to these comments please contact myself on 02 9776 7995 or at dlove@afma.com.au.

Yours sincerely

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