

The Senate

Economics Legislation Committee

Taxation Laws (Clearing and Settlement
Facility Support) Bill 2003

March 2004

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TABLE OF CONTENTS

Membership of the Committee	iii
CHAPTER 1	1
INTRODUCTION	1
Background	1
Purpose of the bill	1
Reference of the bill	1
Submissions	1
Hearings and evidence	1
Acknowledgement	2
CHAPTER 2	3
THE BILL	3
Background to the bill	3
Provisions of the bill	7
Issues raised in submissions	7
Committee's view	11
Recommendation	11
APPENDIX 1	13
SUBMISSIONS RECEIVED	13
APPENDIX 2	15
PUBLIC HEARING AND WITNESSES	15

CHAPTER 1

INTRODUCTION

Background

1.1 The Taxation Laws (Clearing and Settlement Facility Support) Bill 2003 was introduced into the House of Representatives on 4 December 2003 by Mr Ross Cameron, Parliamentary Secretary to the Treasurer. It was passed by the House of Representatives on 10 February 2004, and introduced into the Senate on 11 February 2004.

Purpose of the bill

1.2 The purpose of the bill is to ensure that, in the event that the relevant Minister takes a decision under section 891A of the *Corporations Act 2001* to transfer money from the National Guarantee Fund to another fund for the purposes of clearing and settlement support, the transfer of money does not attract an income tax or Goods and Services Tax liability.

1.3 For clarity, the current bill neither establishes nor changes in any way the Minister's ability to transfer money out of the NGF to another fund for the purposes of clearing and settlement support. This power, together with associated restrictions on its exercise, is already established in the Corporations Act. This bill merely clarifies the tax consequences arising from such a transfer of money.

Reference of the bill

1.4 On 3 March 2004, the Senate adopted the Selection of Bills Committee Report No. 2 of 2004 and referred the provisions of the bill to the Senate Economics Legislation Committee for consideration and report during the sitting week beginning 29 March 2004. The Committee subsequently resolved to report on 29 March 2004.

Submissions

1.5 The Committee advertised its inquiry into the Taxation Laws (Clearing and Settlement Facility Support) Bill 2003 on the internet and in *The Australian* newspaper. In addition the Committee contacted a number of organisations alerting them to the inquiry and inviting them to make a submission. A list of submissions received appears at **Appendix 1**.

Hearings and evidence

1.6 The Committee held one public hearing at Parliament House, Canberra, on Thursday, 25 March 2004. Witnesses who appeared before the Committee at that hearing are listed in **Appendix 2**.

1.7 Copies of the Hansard transcript from the hearing are tabled for the information of the Senate. They are available through the internet at <http://aph.gov.au/hansard>.

Acknowledgement

1.8 The Committee wishes to thank all those who assisted with its inquiry.

CHAPTER 2

THE BILL

Background to the bill

2.1 The current bill relates strictly to the taxation implications of a decision by the Minister under s.891A of the Corporations Act. However, consideration of the Bill requires further background regarding s.891A and the reasons a transfer of money might be made from the National Guarantee Fund under that section.

The National Guarantee Fund

2.2 The National Guarantee Fund (NGF) was formed by the *Australian Stock Exchange and National Guarantee Fund Act 1987*, which also amalgamated the state stock exchanges to form the Australian Stock exchange. The NGF was intended to replace the 'fidelity funds' maintained by each state stock exchange. The Attorney-General, in the second reading speech for the 1987 legislation, outlined the purpose of the NGF:

The associated establishment of a national guarantee fund to replace the existing separate fidelity funds of each of the State capital city exchanges will assist in maintaining investor confidence in Australian securities markets. The 1986 Australian Share ownership survey conducted by the AASE indicated that almost 90 per cent of adult Australians do not own shares. One of the major reasons given by those surveyed was that they preferred safer, less risky, investments. The contract guarantee and insolvency protection afforded by the National Guarantee Fund may serve to alleviate some of these concerns.¹

2.3 The NGF represented an advance on previous investor-protection arrangements because it operated on a no-fault basis and provided easier access to payments:

The no-fault contract guarantees will ensure that where a party to a securities transaction does not complete his obligations, those obligations will be met by the National Guarantee Fund. This no fault system of contract guarantees contrasts with claims against existing fidelity funds under the provisions of Part IX of the Securities Industry Act 1980 where defalcation or fraudulent misuse of property is required to establish a claim. Direct access to the National Guarantee Fund for compensation in respect of a dealer insolvency also contrasts with existing fidelity fund provisions

1 The Hon. Lionel Bowen MP, Attorney-General and Deputy Prime Minister, House of Representatives *Hansard*, 18 February 1987, p. 269.

which only allow for compensation via formal Bankruptcy Act mechanisms.²

2.4 The Securities Exchange Guarantee Corporation (SEGC) was incorporated in 1987 to be the trustee of the NGF.

2.5 While investor protection was always the primary purpose of the NGF, additional uses for the fund were always contemplated, including the provision of financial support for clearing and settlement facilities:

In addition to these investor protection measures, the establishment of the National Guarantee Fund will enable funds to be made available for industry development purposes approved by the Ministerial Council. These funds will comprise the amount of the pooled assets not required for investor protection purposes and it is envisaged that one of the purposes for which such funds will be used is the establishment of a centralised securities clearing house.³

2.6 The NGF was established by merging the assets of the previous state fidelity funds. The value of the NGF at the end of 2001 was \$160 million.⁴

Section 891A of the Corporations Act

2.7 Section 891A of the Corporations Act provides machinery which would enable a Minister to implement Attorney-General Bowen's contemplation of NGF funds being used for a 'centralised securities clearing house'. Subsection 891A(1) provides that:

(1) If the Minister is satisfied that a body corporate specified in regulations made for the purposes of this section has made adequate arrangements covering all or part of the clearing and settlement system support that this Division provides for, the Minister may, in writing, direct the SEGC to pay a specified amount to that body corporate out of the NGF.

2.8 Two organisations have been 'specified in regulations' for the purposes of Subsection 891A(1). Those are the Australian Stock Exchange Settlement and Transfer Corporation Pty Ltd (ASTC) and Options Clearing House Pty Ltd.⁵ Options

2 The Hon. Lionel Bowen MP, Attorney-General and Deputy Prime Minister, House of Representatives *Hansard*, 18 February 1987, p. 269.

3 The Hon. Lionel Bowen MP, Attorney-General and Deputy Prime Minister, House of Representatives *Hansard*, 18 February 1987, p. 269.

4 Securities Exchange Guarantee Corporation, *NGF Information Booklet*, March 2002.

5 Corporations Regulations 2001, Regulation 7.5.85

Clearing House Pty Ltd has been renamed Australian Clearing House Pty Ltd, and is a wholly-owned subsidiary of the ASX.⁶

2.9 Subsection 891A(4) protects the primary purpose of the NGF, namely investor protection:

- (4) Before giving a direction under subsection (1), the Minister must be satisfied that, after the payment is made, the NGF will still have an adequate amount of assets to meet claims.

ASX application for a direction under s.891A

2.10 On 31 July 2003, the Australian Stock Exchange (ASX) applied for a direction under s.891A, directing the SEGC to pay \$93 Million from the NGF to the company now known as Australian Clearing House Pty Ltd (ACH). The ASX outlined the rationale for its application as follows:

As the clearinghouse responsible for *all* clearing services in ASX markets, ACH will perform integrated counterparty risk management and will carry the corresponding counterparty risk. The s891A payment will reflect the transfer to ACH of that part of this total counterparty risk that is currently borne by NGF.

This payment will contribute significantly to the creation of an improved structure for clearing support in the Australian marketplace, further enhancing the domestic and international reputation and attractiveness of Australian financial markets. This new structure will enhance systemic stability by:

- providing a properly capitalised central counterparty which gives investors and market professionals across all ASX markets, confidence that bargains struck on that market will be honoured, consistent with world's best practice in this vital area of financial infrastructure;
- providing the central counterparty with flexible, immediate ability to respond to protect systemic integrity in the event of a default by a clearing participant; and
- enabling improved risk management in the clearing system, consistent with the Reserve Bank of Australia's Financial Stability Standards.⁷

6 The ownership and governance arrangements of ACH were described more fully in evidence before the Committee by ASX CEO Mr Richard Humphry. See the Committee's *Transcript of Evidence*, 25 March 2004, p. 7.

2.11 In February 2004, the Department of the Treasury released a discussion paper entitled *Proposed Direction Under Section 891A of the Corporations Act 2001*, inviting submissions in relation to the ASX's application. The consultation period ended on 5 March 2004. The consultation paper indicates that the Government proposes to make a payment under s891A to ACH. It does not, however, indicate what the size of that payment will be.⁸

Taxation Consequences of a decision under s.891A

2.12 The ASX application included the following reservation:

This application is made on the understanding that any funds paid under the direction of the Minister, pursuant to s891A, are not taxable on receipt by ACH. It is also understood that once the funds are paid out of the NGF, they will be received legally and beneficially by ACH.⁹

2.13 In its submission before this Committee, the ASX stated its concern as follows:

Taxation would result in the loss of approximately one third of the funds currently being used to protect against systemic risk in the Australian equities market. ASX could not justify proceeding in those circumstances.¹⁰

2.14 In the February 2004 consultation paper, Treasury responded to this concern as follows, citing the current bill:

The Taxation Laws (Clearing and Settlement Facility Support) Bill 2003, which will eliminate the tax consequences **at the point of** any payment under section 891A, was introduced into the Parliament on 4 December 2003. Once the payment has been made, tax will be payable as usual.

The ASX has asked that no section 891A determination be made until these amendments are enacted.¹¹

7 Australian Stock Exchange, *Application under Section 891A of the Corporations Act for a payment out of the National Guarantee Fund to Australian Clearing House Pty Ltd*, 31 July 2003, p. 3.

8 Treasury, *Proposed Direction Under Section 891A of the Corporations Act 2001*, February 2004, p. 10.

9 Australian Stock Exchange, *Application under Section 891A of the Corporations Act for a payment out of the National Guarantee Fund to Australian Clearing House Pty Ltd*, 31 July 2003, p. 3. See also p. 5.

10 Submission 3, Australian Stock Exchange, p. 3.

11 Treasury, *Proposed Direction Under Section 891A of the Corporations Act 2001*, February 2004, p. 15. Emphasis in original.

Provisions of the bill

2.15 The provisions of the current bill are straightforward. It contains one substantive section (section 3) and its key provision is subsection 3(1), which reads:

(1) No consequences arise, for the purposes of any Commonwealth laws relating to:

- (a) Tax for which liability is worked out under the income tax law;
- or
- (b) GST;

In respect of a payment under subsection 891A(1) of the *Corporations Act 2001*.

2.16 The Explanatory Memorandum explains the subsection as follows:

There will be no taxation consequences under Commonwealth income tax and GST laws as a result of a payment out of the NGF under section 891A of the Corporations Act.¹²

Issues raised in submissions

2.17 The Committee did not receive any submissions or evidence opposed to the bill. Further, the Committee did not receive any submissions or evidence opposed to the Government's proposal to make a direction under s.891A. Evidence sought by several Senators during the hearing related more to the regulatory issues underpinning the bill. In particular, Senators canvassed the quantum of funds to be transferred, and to the related issue of whether caps should be imposed on investor payments from the NGF. These issues were raised in accordance with the Selection of Bills Committee's direction that the Committee consider the Bill 'and related matters'.¹³

Evidence related to the provisions of the bill

2.18 The submission from the Australian Stock Exchange sets out its wider program of internal restructuring to harmonise with international best practice, and indicates the proposed role for ACH as 'the central counterparty and clearing facility for all ASX markets, providing all clearing and counterparty risk management services'.¹⁴

2.19 The Australian Shareholders' Association stated in its submission that it 'supports the intention to restructure the National Guarantee Fund to clearly separate investor

12 Explanatory Memorandum, para 1.11, p. 4.

13 Selection of Bills Committee Report No. 2 of 2004.

14 Submission 3, Australian Stock Exchange, p. 3.

protection from clearing support and the intention to prevent any inappropriate taxation consequences.¹⁵

2.20 The Reserve Bank of Australia stated its support for the bill, and noted that a direction under s.891A is necessary for best practice in counterparty risk management:

The Bank has been in favour of restructuring the NGF to clearly separate the funds dedicated to investor protection from those intended to provide clearing support. Clear delineation of these two functions would represent international best practice in this area and we have been working with ASX, ASIC and Treasury towards this end. A satisfactory resolution of this matter would provide the ACH with one means to meet a key requirement of the Reserve Bank's Financial Stability Standard for central counterparties.¹⁶

2.21 The SEGC submitted to the Committee a copy of its submission to the Treasury's February 2004 consultation paper, in which it states:

SEGC agrees that there is justification for separating the functions of investor compensation and clearing and settlement support by way of a payment out of the NGF under section 891A of the Corporations Act.

SEGC has indicated in previous submissions that it considers that the removal of the clearing and settlement support role from the NGF is essential for future developments in financial markets in Australia.¹⁷

Evidence relating to the size of any transfer

2.22 While the Committee recognises that the quantum of funds to be transferred is a decision for the Minister under s.891A, Committee members were concerned to ensure that any transfer of money to ACH leaves sufficient funds for investor protection. To that end, Senators questioned witnesses about the actuarial analysis underpinning the advice upon which the Minister would base his decision.

2.23 In preparing for the ASX's application for a decision under s.891A, the SEGC commissioned Pricewaterhouse Coopers (PwC) to report on the assets which would be required to meet claims under the NGF. In evidence, officers from Treasury indicated that the Australian Government Actuary had assessed the methodology used by PwC, and considered it to be appropriate.¹⁸

15 Submission 2, Australian Shareholders Association, p. 1.

16 Submission 1, Reserve Bank of Australia, p. 1.

17 Submission 4, Securities Exchanges Guarantee Corporation Limited, Attachment 1, p. 2.

18 *Transcript of Evidence*, 25 March 2004, Smith, pp. 11-12.

2.24 The PwC report indicated that the assets required by the SEGC would be \$51 million if the proposed capping arrangements were in place (see below) and \$72.5 million under current arrangements. In evidence, Ms Ruth Smith, Manager, Market Integrity Unit, Department of the Treasury, indicated that because of the time that has elapsed since the PwC report which was presented on 29 October 2002, the numbers will need to be revised by PwC before final advice is offered to the Minister.¹⁹

Capping of payments from the NGF

2.25 As noted above, the amount of assets required by the NGF will depend on the outcome of a related proposal to cap payments from the NGF. This proposal was canvassed in the Treasury position paper *Compensation for Loss in the Financial Sector*, which was released in December 2003. The position paper outlined two options for capping: either limiting the NGF's coverage to retail investors, or providing a cap of \$500,000 per claim.²⁰

2.26 The Committee observes that these two options really had the same purpose: that of ensuring that the NGF could not be 'wiped out' by a large claim from a wholesale investor. This concern might be characterised as ensuring that the NGF would continue to have adequate funds to protect smaller, and in particular retail, investors. In evidence, Mr Richard Humphry, CEO of the ASX, stated:

... at the moment, because it is uncapped, very large participants in the market—the institutions—could effectively wipe out the fund with one claim. That has not happened to date, principally because we have other mechanisms with which we very strictly monitor the market, but the risk is always there.²¹

2.27 The Committee notes that there are two major unresolved issues in relation to a possible cap on payments from the SEGC. First, it is not clear whether the limited factor should be the type of market participant (i.e. retail investors) or a dollar figure, such as the proposed \$500,000 figure.

2.28 Second, if a dollar figure cap is imposed, it is not clear why \$500,000 would be appropriate. The Committee noted evidence that only four of the payments from the SEGC have ever exceeded \$500,000, and that only one of these has been from a retail investor.²² However the Committee was not left with a sense that the analysis underlying this decision matched the level of analysis undertaken to reach a view about the size of the proposed transfer under s.891A:

19 *Transcript of Evidence*, 25 March 2004, Smith, p. 14.

20 *Compensation for Loss in the Financial Sector*, December 2003, pp. 38-40

21 *Transcript of Evidence*, 25 March 2004, Humphry, p. 5.

22 Submission 4, Securities Exchanges Guarantee Corporation Limited, Attachment 1, p. 4.

Mr Humphry—Our research shows that about 51 per cent of the adult population have share ownership. Most of those are not very active but there are some increasingly sophisticated investors amongst that group. We are trying to look forward and say that, with an ageing population with increasing assets, \$500,000, given the history, would be quite sufficient to protect all individuals.

Mr Hamilton—The \$500,000 cap is also mentioned in the Corporations Law as a ‘sophisticated investor’ delineator, for prospectuses and that kind of thing. So it also seemed to be something that had some legislative support.²³

2.29 If a dollar figure cap is imposed, a more rigorous actuarial analysis of the precise figure should be presented, perhaps alongside the updated PwC report foreshadowed by Treasury.

2.30 Finally, the Committee notes that the Treasury Consultation Paper *Proposed Direction Under Section 891A of the Corporations Act 2001* leaves open the capping issue, and seeks further comments.²⁴

Earnings generated from funds transferred under s.891A

2.31 The final issue considered by the Committee was the distribution of earnings generated by investment of the funds transferred to ACH under any direction made under s.891A. These earnings would be significant in value. If, as the ASX hopes, \$93 million is transferred to ACH, then earnings 'would probably be around \$4 million with about \$1 million in tax.'²⁵

2.32 As suggested above, earnings would be subject to taxation²⁶ but such earnings were not expected to be sufficient to meet the growth requirements of the fund, if it is to continue to meet its risk management requirements:

there will not be, under any scenario, sufficient funds to meet all of the needs. Therefore, ASX will have to supplement the fund to some degree. We do not know how much at this stage, because it is really the difference between the fidelity fund and the other. I suggest that any earnings on those funds will be needed to simply keep pace with the size of the growth the capital market is underwriting.²⁷

23 *Transcript of Evidence*, 25 March 2004, Humphry, Hamilton, p. 5.

24 *Direction Under Section 891A of the Corporations Act 2001*, February 2004, pp. 7-8.

25 *Transcript of Evidence*, 25 March 2004, Humphry, p. 9.

26 *Transcript of Evidence*, 25 March 2004, Humphry, p. 8.

27 *Transcript of Evidence*, 25 March 2004, Humphry, p. 9.

2.33 The Committee noted the important undertaking given by the ASX that income earned by ACH as a result of investing funds transferred from the NGF would not be distributed to shareholders:

I am perfectly happy to give an undertaking that it is not going to be used for that purpose.²⁸

Committee's view

2.34 The Committee considers that, as no evidence opposing the bill has been received, the bill should be passed unamended.

2.35 The Committee notes that the Department of the Treasury continues to undertake extensive consultation with interested parties in order to inform the Parliamentary Secretary's decision to issue a direction under s.891A.

Recommendation

The Committee recommends that the Senate pass the Bill.

SENATOR GEORGE BRANDIS

Chairman

APPENDIX 1

SUBMISSIONS RECEIVED

- 1 Reserve Bank of Australia
- 2 Australian Shareholders' Association
- 3 Australian Stock Exchange
- 4 Securities and Exchange Commission Guarantee Corporation

APPENDIX 2

PUBLIC HEARING AND WITNESSES

THURSDAY, 25 MARCH 2004 – CANBERRA

DEPARTMENT OF THE TREASURY

GALLAGHER, Mr John, Manager, Business Tax Base Unit, Business Income Division

SMITH, Ms Ruth Viner, Manager, Market Integrity Unit, Corporations and Financial Services Division

AUSTRALIAN STOCK EXCHANGE

HAMILTON, Mr Christopher John, Executive General Manager, Clearing and Settlement

HUMPHRY, Mr Richard George, AO, Managing Director and Chief Executive Officer

JONES, Ms Christine Anne, General Counsel

AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

LYONS, Ms Tracey, Manager, Policy and Markets Regulation

O'DONNELL, Ms Jennifer, Deputy Executive Director, Policy and Markets Regulation

SECURITIES EXCHANGES GUARANTEE CORPORATION

PALMER, Ms Sally, Manager and General Counsel