Australian Shareholders' Association
Australian Shareholders' Association Limited
Suite 301 90 Pitt Street Sydney NSW 2000
GPO Box 359 Sydney NSW 2001
t 02 9223 8811
f 02 9223 3964
e share@asa.asn.au
ABN 40 000 625 669

31 March 2014

Financial System Inquiry
GPO Box 89
Sydney NSW 2001

SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY BY AUSTRALIAN SHAREHOLDERS ASSOCIATION

Background

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. ASA is an independent not-for-profit organisation funded by and operating in the interests of its members, primarily individual and retail investors, self-managed superannuation fund (SMSF) trustees and investors generally seeking ASA's representation and support. ASA also represents those investors and shareholders who are not members but follow ASA through various means, as our relevance extends to the broader investment community.

We note that the Financial System Inquiry (Inquiry) is charged with examining how the financial system could be positioned best to meet Australia's evolving needs and support Australia's economic growth. Our submission is intended to provide recommendations that foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of ASA's members, being retail investors in public listed entities. Many of our members are also trustees and beneficiaries of self-managed superannuation and pension funds, so our submission reflects this aspect of investors' interests as well. Whilst we have around 6,000 members, we are the only body representing this sector of the Australian financial community that has an active position in seeking to achieve improvement in the management of public listed entities; in our monitoring programme, volunteer monitors are generally prominent at annual company meetings questioning directors on performance and governance issues. Our comments in this submission are concerned mainly with the needs of the retail financial sector, its investors and consumers; for wholesale borrowers and investors the financial system appears to be (generally) functioning well.

ASA's response to the terms of reference

We respond to the terms of reference (TR) (our response in normal font, terms in italics) as follows:

1. *The Inquiry will report on the consequences of developments in the Australian financial system since the 1997 Financial System Inquiry and the global financial crisis, including implications for:*

1.1. how Australia funds its growth

Retail investors, both directly and indirectly — through financial institutions — are already important providers of capital to fund Australia's growth; this contribution will increase with the continuing expansion of the superannuation sector;

1.2. domestic competition and international competitiveness

The consolidation of the Australian banking sector has strengthened the financial system, but has perhaps dulled genuine innovation (with many "me too" products and services); after an initial period of more competitive pricing for system users, the trend has stalled, maintaining relatively high pricing and profit margins for banks and investment institutions by comparison with their international peers.

1.3. the current cost, quality, safety and availability of financial services, products and capital for users

There is a crucial need for much greater financial literacy throughout the Australian population: this is the dominant and fundamental problem that needs to be tackled, and it affects the whole of the (retail) financial system. As we state in Section 2.4, this must start in schools — which has belatedly been recognised. Although financial literacy has improved over the last 10 years, thanks to efforts by regulators, Government and in particular voluntary bodies, including ASA, much more needs to be done. This theme is fundamental to several of the TR. Although there has been a proliferation of financial products and services in recent years, some of this development has come with high costs, to the detriment of consumers. This is a problem throughout the consumer sector, for both users and providers of capital. For example, relatively poor consumers have gravitated to (or been driven to) the fringe lending sector; and investors have been at risk of inappropriate or conflicted financial advice, or have invested in complex products without understanding their risk/reward characteristics. The public must be well educated in financial matters to minimise market failure. Financial hardship and predatory activity are persistent problems that have been recurring for decades, despite improvements in legalisation. This again highlights the need for financial literacy — and better resources and powers for regulators so that they can obtain redress and enforcement more quickly.

The need for improved financial literacy goes hand in hand with FOFA, although it affects all aspects of finance, irrespective of whether advice is given. The recent FOFA reforms were welcome, but did not range widely enough. Although the financial planning sector has increased its professionalism, there is still too much conflicted advice, obscuring the distinction between advice and sales. In contrast to the new Government's current policy, we believe that the FOFA reforms should not only be retained but extended to cover the credit and insurance sectors. Considerable improvements are needed in life and general insurance — see Section 4.3. Consumer protection needs to be strengthened in those sectors generally, irrespective of whether financial advice is involved. The Inquiry also should assess whether financial advisers have adequate PI insurance, and whether that regime is robustly regulated and monitored.

We urge Government to implement swiftly the recommendations by APRA and ASIC to strengthen disclosure and the protection of depositors and investors in nonbank finance companies; these are often conduits for high risk property development finance and have caused large investor losses.

There is a paradox that there is almost too much "availability" of products and services that people can buy; yet there is not enough "access" for poorly informed consumers to unbiased advice and counselling. The profusion of financial services, and increasing vertical integration of banks, wealth managers and financial planners, makes the need for high quality, unconflicted advice paramount. The websites of several regulators and industry bodies do provide useful information for consumers, but the challenge is to make consumers aware that these exist.

ASA is also concerned that the charging of fees based as a percentage of funds under advice or management (FUM) throughout the funds management industry bears no relationship to the cost of providing the services to individuals. The financial advice sector has been moving away from ad valorem fees to fees for service — both through best practice voluntary changes and more recently FOFA — however, it is still the almost universal method in the retail funds management sector. Industry super funds have generally split their fees between administration fees (to recover the cost of managing the account, providing personnel, services and system infrastructure etc) as a flat cost per annum, and investment managers' fees based on FUM (whether for in-house or outsourced investment management); the for-profit sector charges all fees as percentages based on FUM. (These comments exclude fees for specific requests such as switching costs or family court certificates etc.) Some funds charge a performance fee, in addition to a base fee, when investment returns exceed a benchmark; needless to say, no rebate is given when subpar performance occurs. We would hope that competitive forces will encourage a reduction in base fees, as a trade-off for performance fees, and also as the FUM of the whole sector grows.

The comments above relate to the funds management sector in general; as a more specific point, ASA believes that the superannuation sector is benefiting too much from ad valorem fees when much of its net inflow is attributable to compulsory, and rising, employer/SG contributions. The fact that the same percentage fees are levied, when the marginal costs would be very small, gives the industry a windfall benefit from compulsory super at the expense of the public. Although initiatives like MySuper will help mitigate costs, we feel that the Inquiry should examine whether this aspect of the superannuation system is fair and efficient, rather than unfair and anticompetitive.

2. *The Inquiry will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including:*

2.1. balancing competition, innovation, efficiency, stability and consumer protection

As noted in Section 1, FOFA and other consumer protections must be retained and strengthened to ensure efficiency, stability, transparency and consumer protection, whilst not impeding fair innovation and competition. High prices and price gouging are, unfortunately, not illegal — and probably too hard to define — but this reinforces the need for widespread financial literacy and counselling services.

The regulatory framework distinguishes between retail, sophisticated and wholesale investors. Although this mostly works effectively, there are risks that even a sophisticated investor could suffer because of the lower disclosure requirements that apply to (non-prospectus) offers to wealthy investors. Conversely, some investors are very experienced but not wealthy enough to be able to make individual investments at the minimum $500,000 level required to qualify as wholesale investors, and are thus unable to participate in potentially attractive investment opportunities. The Inquiry could consider whether these distinctions are too rigid, or could be better managed by giving ASIC wider powers to require explicit investment warnings in offering materials.

Efficiency is a desirable objective, but this drive has caused consolidation in the banking sector — where the benefits have largely been captured by banking groups rather than their customers. Conversely, many identical products and services (especially in retail funds management) are available from many providers — in theory this should enhance competition but it may just create multiplication of costs and inefficiency. (See also product bundling in Section 4.3).

The successful establishment of Chi-X has been beneficial to liquidity and pricing in listed markets. We hope that the ASX's AQUA system will be similarly successful, and provide competitive pressure to drive down managed funds' platform costs. Although we note the existence of much smaller competing stock exchanges in Australia, we think that precisely because their capital raising rules are less stringent than for ASX, and often the raisings are small, these sources of capital should be closely monitored by regulators to ensure that their capital raisings meet satisfactory levels of disclosure and transparency. (See also Section 3.2).

2.2. how financial risk is allocated and systemic risk is managed

The Government guarantee of deposits up to $250,000 in ADIs should be retained, although the Inquiry may wish to consider whether the guarantee fees charged are appropriate; similar comments apply to the RBA liquidity scheme for banks.

The Australian general insurance sector appears to be heavily reliant on overseas reinsurers to lay off its risk. The availability and cost of reinsurance fluctuates widely; the length of reinsurance covers seems usually to be rather short term. We would welcome the Inquiry examining whether Australia's reliance on and access to foreign reinsurance — in life but more so in general insurance — is robust and appropriate for the long term.

The Australian financial system is intensely exposed to the housing sector. We recommend that the Inquiry review (with APRA) the system-wide consequences of a sharp and widespread decline in housing prices. The largest Australian banks (and some other major financial institutions) have substantial operations and exposures in New Zealand. Although the TR are expressed in terms of the Australian financial system, the question of imported systemic risk needs to be considered, especially with reference to the New Zealand economy and its housing sector. The theme should also be considered more broadly, as the Australian banks extend their overseas operations.

APRA-regulated super funds have the challenge of investing money for a very wide demographic group — where some members may have over 40 years before retirement, others are nearing retirement and some have already reached the pension phase. This creates difficulty in blending asset management and portfolio styles that will meet the needs of all members. In particular, there is the paradox that most fund members will stay in the fund for many years, or decades, yet they have the right to transfer their balances to another fund at short notice; we understand that such a request must be effected within 30 days. Thus, even though it is necessary that nearly all of the investment management and asset allocation be designed for the long term, the funds need to have sufficient liquidity to be able to transfer member balances at short notice. We note that in the GFC, a few funds were caught with high concentrations of illiquid property, infrastructure and other "alternative" assets, with a consequential stress on their liquidity. This occurred at a time of anxiety in the economy, when fund members who had passed the preservation age could have taken their money out if they had wanted to — and other members could have demanded a transfer to other funds, if they were concerned about the stability and health of their existing fund. We do not know if any super funds did experience a "run" of withdrawals, but the potential appears to exist at a future time of crisis.

The ageing population means that an increasing stream of withdrawals will be made from super funds — either as pensions or lump sums. Although fund inflows will continue to be very substantial, the large net cash inflows of recent years will no longer be able to be taken for granted, and suitable liquidity arrangements must be made system-wide (and no doubt have been in many cases).

We are not aware what provisions (if any) APRA or other bodies have made to deal with such a contingency. We suggest that an emergency liquidity scheme could be established, under which either a Government body could provide a lender of last resort facility — at a suitably expensive fee — or the industry itself could provide a club facility of mutual assistance (along the lines of the EIB, IMF, ECB emergency action in recent years to help European banks and sovereigns). Such a facility could be either funded (for example, by levying a payment of say one basis point per annum on each fund's FUM, paid into an independent special purpose emergency fund, or unfunded, with an emergency credit line from the Government or RBA, for example. There are no doubt many complexities, and the matter of moral hazard to consider; we do not wish to make prescriptive suggestions, but note that APRA-regulated super funds have now become so large (as a sector, and in some cases individually) that a liquidity crunch or failure could impose systemic risk. Just as some Australian banks are "too big to fail", some super funds probably are as well. Confidence in the entire financial system must be unquestioned.

2.3. assessing the effectiveness and need for financial regulation, including its impact on costs, flexibility, innovation, industry and among users

Regulation obviously has a cost, but it is a necessary element of a well functioning and mature financial system. Australia's financial system appears to be (largely) very open and it is doubtful that regulation has stifled innovation and flexibility. However, there is public concern that both statutory and negotiated penalties for financial wrongdoing, for example, for market rigging, insider trading and misleading or unconscionable conduct, are too low. Both fixed and maximum penalties (especially financial penalties) should be increased to levels which are a serious deterrent to wrongdoing; and this must apply to individuals and bodies corporate. ASA suggests that penalties for some offences should be uncapped, so that regulators and the courts may impose penalties that are up to a multiple of three to five times the benefit gained from committing the offence, as we understand is the case with some ACCC penalties. There should also be a "disgorgement power". We therefore welcome the recent report (REP387) from ASIC on this subject.

Sector-specific legislation is necessary for credit, investments, deposits and insurance. In respect of the fringe lending sector, this is discussed in detail in ASIC's submission No 45 to the Senate Inquiry. There is a need for much stronger regulatory oversight and intervention in that sector, including pay day lending, credit repair and related predatory businesses, where consumers are paying very high rates of interest and costs that tend to entrench or exacerbate financial hardship. There are no reliable statistics on the size of this sector: this may be because the definitions are vague. There are estimates of about $3 billion, with one or two million Australians persistently indebted for average amounts of $2,000 to $3,000. It is believed that funding for pay day loans made by the fringe lending sector is provided by the banking system, and that rates on this finance are high, yet acceptable to the sector as their own lending rates and fees rates are higher again. There is anecdotal evidence that banks are not lending amounts up to $5,000 to customers and instead they refer applicants to the fringe lending sector. If this is true, it represents a dangerous conflict of interest as well as being an ethical problem. See also Section 4.3 for our comments on microfinance.

There is also a need to prevent exploitation of older people through reverse mortgage schemes, unscrupulous attempts to get access to the equity in retirees' homes and early release schemes seeking dishonest access to superannuation balances.

We applaud ASIC's current focus on complex investment products (see REP384), which investors can be enticed to invest in without properly understanding what they are buying. These products do have legitimacy, at least as primary issues to raise new capital, rather than as secondary artificial, speculative or arbitrage arrangements; however, because of their complexity and variability, they cannot be comprehensively policed by regulation alone. ASIC should extend its surveillance of complex products through their whole life cycle, not just up to the point of sale; often product promoters lose interest once the product has been sold and fees locked in, and the quality of reporting to investors declines, especially for unlisted products.

2.4. the role of Government

As noted in Section 1, there is a continuing need for widespread improvement in financial literacy, both at adult and school levels. Government can take a leadership role here, in conjunction with regulators, financial institutions and non-profit bodies. Substantial and continuing monetary investment is required, by Government and industry, in both financial literacy and financial counselling. The cost of such funding is very small by comparison with the profitability of the financial sector, and also with the cost to the economy of users suffering loss through predatory behaviour, receiving bad advice, overpaying for credit or being persuaded to invest in unsuitable products or insufficiently regulated sectors or markets. We understand that the Government may be considering reducing or cancelling its $20 million p.a. contribution to financial counselling organisations, when the current funding contracts expire this year. If true, that would be severely deleterious to the public interest and the economy: the current demands on such services already outweigh the human resources and funding available; the cost to the economy through failure to maintain this vital work would be a very large multiple of the support funding required.

The purpose of regulatory impact statements is valuable, but their objectives have changed under the new Government. Cost/benefit analyses are now to be assessed on net cost to the industry, not to the economy as a whole. This political shift is not in the interests of a balanced economy.

ASIC's main submission to the Senate Inquiry (October 2013) stated that its interventions had obtained $349 million of compensation for consumers over the last three years, and showed also its 10 largest settlements over 2008-13. These results are impressive, but we suspect would represent only a small percentage recovery of investors' and consumers' losses over that period. We note and accept that ASIC says, quite fairly, that a regulator's role cannot be to prevent every loss. As we stated in Sections 2.3 and 2.5, greater surveillance and intervention would clearly help narrow this gap, as would greater penalty powers. In addition, we suggest that the Inquiry should consider the need for a statutory compensation fund for losses resulting from investment failure and wrongdoing.

2.5. the role, objectives, funding and performance of financial regulators including an international comparison

Australia has not suffered the same degree of financial damage as many other countries from the GFC and explosion of credit since 2000 (although it could be argued that this has distorted the housing market). To a large extent this is attributable to strong regulation by APRA and ASIC, as well as RBA responsiveness. We suggest that ASIC's recurrent funding should be increased to enable more extensive and timely surveillance, and faster enforcement and redress where necessary. ASIC's resources are modest for the breadth of the market sectors that it is tasked with regulating and monitoring.

There is some evidence of market failures caused by a lack of clarity of the boundaries between the scope of various regulators or market operators, for example, between ASIC, APRA and ASX. For system users, it would be better to tolerate possible overlap between regulators' purview, rather than risking gaps and loopholes, which can lead to losses and consumer harm. Gaps in the scope of the regulatory system act against the interests of efficient capital provision and its usage by the retail sector. It is inevitable that unscrupulous parties will try to exploit these gaps, and regulators need stronger powers and penalties. ASIC's powers of intervention, enforcement and ability to insist upon consumer warnings in product offerings could usefully be strengthened.

3. *The Inquiry will identify and consider the emerging opportunities and challenges that are likely to drive further change in the global and domestic financial system, including:*

3.1. the role and impact of new technologies, market innovations and changing consumer preferences and demography

We note the advent of peer-to-peer lending and crowd sourced equity funding (and CAMAC's current inquiry on the subject). These are welcome innovations which could increase competition and open up new cost-effective capital sources, but they will need careful monitoring to avoid fraud and misleading conduct. An intermediate course, which could provide a greater degree of control and investor safeguard, would be to modify S 708 of the Corporations Act to enable small capital raisings to be made to larger groups of suitably qualified investors — perhaps 50 or 100. This could help reduce the funding gap discussed in Section 3.3.

3.2. international integration, including international financial regulation

Approximately 5% of entities listed on the ASX are incorporated outside Australia. Although they must comply with the ASX Listing Rules, there are some important requirements of the Corporations Act that they are not obliged to meet, for example, related-party transaction disclosures, the provision of a remuneration report and the takeovers law. We believe that all relevant provisions of the Corporations Act should apply to all listed entities, irrespective of which Australian exchange they are listed on and irrespective of their country of incorporation; where the entity would be subject to conflicting (overseas) law and disclosure requirements, the more rigorous regime should prevail.

We are concerned that the smaller Australian stock exchanges could be used to raise capital from overseas investors who may be ignorant of the processes required under Australian law. It would be of even greater concern if the reverse were to happen; namely, that Australian investors could buy securities from an apparently Australian issuer (or on a secondary market) when in fact the business is largely or entirely conducted and managed overseas. Regulators will need to watch these developments to ensure that the lower listing costs and less demanding listing criteria on these junior exchanges are not offered at the expense of poorer disclosure and higher risk.

3.3. *changes in the way Australia sources and distributes capital, including the intermediation of savings through banks, nonbank financial institutions, insurance companies, superannuation funds and capital markets*

The extraordinary growth of SMSFs has been an expression of investor independence, and perhaps has encouraged some reduction in fees charged by retail fund managers; however, there is evidence of some exploitation of SMSFs by service providers and property promoters. The regulators are aware of this. There may also be a need for surveillance (rather than legislation) by ATO and ASIC to determine whether SMSF owners have unsuitable asset concentrations or levels of borrowing.

The growth of industry funds, especially as public offer funds, has also been a strong source of competition to retail for-profit fund managers. There is still rhetoric about them being supposedly union dominated; this is unproductive. It is likely that investments by the general public in the industry funds now exceed $100 billion — publication of such statistics would inform debate on their role in investment markets.

Reporting and governance practices by APRA-regulated funds have been substandard and under-regulated by comparison with listed entities; the recent Treasury inquiry seeking to improve reporting and governance (and the FSC voting and reporting standards) is welcome and long overdue. It is absurd that, at present, the disclosure obligations for a $20 billion super fund are much less demanding than for a $20 million listed entity. In principle, reporting and governance requirements for APRA-regulated funds should be at least of a similar standard and scope as for listed entities.

We urge Government to implement promptly the recommendations by ASIC and APRA to strengthen disclosure and depositor protection at nonbank finance companies.

We note that there have been a number of debates on the need to foster a deeper primary and secondary market for corporate bonds, and that the previous government tabled the Simple Corporate Bond Bill in 2013. Although there may be argument about its precise form and terms, we believe that this would be a welcome development in Australian capital markets, with twin benefits. It could open up a significant new source of capital for companies (especially those that may not be large enough to get access to overseas wholesale markets) and would offer a new asset category with higher yields than cash deposits or government bonds, but be less risky than equities, and over time promote a wide choice of issuers. This should be attractive to individual investors and SMSFs in particular. It could also have an indirect benefit in providing a strong and straightforward alternative to the various types of complex products, which are often confusing, opaque, risky and illiquid.

The aggregate balances of super funds are already over $1.5 trillion — this sector will soon approach the value of the ASX total capitalisation and the size of Australia bank deposits. The increasing prominence of super funds highlights the need for a comprehensive range of asset classes available to the funds (especially APRA regulated) to invest in. There is debate that Australian super funds are too heavily invested in equities (in particular domestic equities) by comparison with other OECD countries. It's unclear whether this is a cultural preference or is partly caused by a shortage of investible assets in other classes, for example, bonds (both corporate and government) and infrastructure.

There is opportunity for development of a listed corporate bond market for retail investors (see above) and also the provision of nonbank finance (both debt and equity) to fund long-term infrastructure projects. This would enable productive investment in infrastructure, to the good of the economy, and assist portfolio diversification through assets that have a degree of inflation protection and low correlation with other markets. It is arguable that the different capital adequacy features of super funds would make them a cost-effective alternative to the banking system.

In the years before the GFC, banks had become more willing to offer long-term funding for project finance, including infrastructure funding. This was severely restricted through the GFC; although banking terms have improved since, we understand that banks are still reluctant to provide much funding for terms over 10 years, when some projects ideally need debt with terms of up to 30 years. Certainly, Australian funding for terms exceeding about 10 years is insufficient to meet the demands. Stronger companies have bypassed the banks and gone to US institutional markets to raise very long-term funds. We are not aware whether this market will also provide 15+ year finance to single projects rather than corporates. The need for finance repayable over 15 or 20 years, or longer, to fund major projects, would seem a good match for the super funds and life insurers (and annuity providers), which need stable very long-term assets with inflation linked returns. This is of course already occurring, and the increasing growth and professionalism of large super funds should provide a welcome source of capital for this growing asset class.

On the other hand, large super funds (and other institutions) appear to provide very little finance to support the Australian venture capital sector and similar early stage business development; such funding is often raised from “angel” investors or through overseas specialist managers. This constrains what could otherwise be a vibrant sector that could provide attractive returns. Such longer term investment opportunities should be encouraged for super funds, but not mandatory. In contrast, most Australian private equity funds appear to target almost exclusively existing businesses for improvement and expansion; while this can be a useful activity, it is disappointing that little of this funding assists the formation of new businesses.

3.4. changing organisational structures in the financial sector

Increasing consolidation in the banking sector has enhanced system strength but perhaps hampered competition and created a two-tier financing system, where the big four banks enjoy better and cheaper access to both retail and wholesale sources of finance than do the smaller banks, credit unions and other financial intermediaries. It appears that even years after the disruptions of the GFC have dissipated, the costs of raising retail and wholesale funds, and returns on assets, are not a continuum that accurately reflects risk: this impedes competition from smaller financiers. There is scope for this to be counterbalanced by the larger super funds investing directly in corporate debt and project debt or equity, especially to finance infrastructure projects. Such investment should be discretionary, not subject to external direction.

The absence of a level playing field is not limited to the direct cost of capital; the large banks have too much latitude in self-assessing their credit risk-weighted assets, leading to systemic risk of under-providing capital and using this as a competitive advantage to enhance ROE at the expense of smaller financiers. This should be discussed with APRA.

Increasing vertical integration, with banks and major insurers owning financial planning networks, deters innovation, market transparency and competition, and increases the likelihood of conflicts of interest. See also comments in Section 5.

3.5. *corporate governance structures across the financial system and how they affect stakeholder interests*

Corporate governance practices have improved greatly over the last 15 years, partly by voluntary initiative, partly guided by law and the ASX Listing Rules, and also by standards developed by industry bodies. ASA has participated in the recent work by the ASX Corporate Governance Council to develop its third edition of Corporate Governance Principles and Recommendations. Although listed entities have improved the professionalism of their engagement with institutional investors, there is often lower quality and depth of engagement with retail shareholders — even for companies with over 100,000 retail investors. Listed entities must recognise the need for regular and constructive engagement with all their capital providers, and other stakeholders. As we discuss in Section 5, it is very disappointing that the requirements for annual meetings of trusts are much more limited than those for companies. We acknowledge that some listed trusts/ responsible entities (RE) do choose to hold annual information meetings anyway, but the trust sector represents a material part of the listed market and the "second class" treatment of the trust sector's investors is unacceptable (see Section 5h). We note that CAMAC is due to release its report on the future of AGMs: we hope it will focus on the commercial benefit and substance of universal investor engagement, rather than the legal technicalities of "form" that have to date dominated debate on this subject. Although it is more a matter of law and disclosure, rather than finance, we believe that notices of meeting have not shown the same improvements as governance generally. Retail investors would benefit from notices that are more genuinely informative and comprehensive on the substance and commercial context of some resolutions, rather than the almost total emphasis on the legal form.

There has been a recent improvement in the quality of information in annual reports under the heading of "Operating and Financial Review". However, in some cases this still falls well short of the objectives discussed in ASIC's Regulatory Guide 247; boards have argued that there is inadequate legal protection for directors making "forecasts" or similar predictions in good faith, which may turn out to be wrong. Since this is such an important purpose of annual reports — to look to the future rather than concentrate mainly on the past — it would be helpful for the Inquiry to foster debate on the claimed (and disputed) need for a "safe harbour" defence.

The RE regime has in a number of cases been a signal failure for investors (see Section 5b); despite CAMAC's report two years ago, it would be timely for the Inquiry to reconsider whether REs should be abolished.

We welcome the recent Treasury Inquiry into the governance and reporting of non-SMSF super funds, and stronger FSC and APRA guidelines on disclosure of institutional voting. As discussed in Section 3.3, these improvements are sorely needed and we hope that the Government will enact them quickly.

3.6. developments in the payment system

We have no comment under this heading.

4. The Inquiry will recommend policy options that:

4.1. promote a competitive and table financial system that contributes to Australia's productivity growth

4.2. promote the efficient allocation of capital and cost efficient access and services for users

See our comments in Sections 1.3, 2.1 and 3.2.

4.3. meet the needs of users with appropriate financial products and services

Please see comments above regarding the need for financial literacy and in Section 2.3 on the fringe lending sector; and regarding the need for a responsible microfinance sector to be developed, perhaps by the major banks. Some products in the fringe lending sector, for example, pay day loans, may (despite their high cost) be helpful if used only once, but consumers are suffering through repeated use of such services (whether through misunderstanding, misinformation or desperation). Longer term and better value alternatives are badly needed.

Despite regulatory action, merchants are still charging excessive surcharges, which are well above the credit card providers' charges.

In addition to our comments in Section 2.3, banks are indirectly benefiting from the fringe lenders' operations by charging multiple penalty fees for minor delays and faults, and failing to act responsibly regarding direct debit cancellation instructions and fees. Shadow shopping surveys report a disappointing level of adherence by banks and mutuals to their own codes of conduct regarding direct debits. Further work is needed on credit card surcharges and bank penalty fees.

In life insurance, there has been excessive switching ("churn") of clients between life insurers to maximise upfront sales commissions. Churn can cause significant detriment to consumers, including cases where consumers have received inferior policy terms, paid more for cover or had claims denied where they previously had cover. Life policies are sold on very high commissions, for example, 115% to 160% of the premiums in early years. Unscrupulous financial planners have a strong incentive to sell policies, so the customers cancel and buy new ones. The average policy is in force for only six years. Australian life insurers have (also) suffered large losses in the last two years as customers have cancelled policies or made big claims on disability cover. Insurers are responding by making large increases in premiums for both individual and group cover. We understand that the FSC had considered a code to moderate the churn practice, but it did not proceed. We hope that the FSC will persevere with its code, or that legislation will be introduced to combat this misselling. If the code had proceeded it would have removed or at least reduced the incentive to churn in the first few years, by imposing commission claw back. Life insurance pricing is clearly unsustainable if such huge commissions are paid and policies are being churned so frequently.

The commissions ban in the FOFA reform package does not apply to the sale of retail life insurance outside superannuation: this should be extended immediately to improve transparency and create a sustainable business model for life insurers, their clients and shareholders.

Bundling of products and covers occurs in general insurance — which creates inefficient and overpriced products that consumers (at least partly) don't want. We recognise that it would not be feasible for all consumers to design bespoke insurance polices to suit their own preferences, but there is scope for some unbundling of covers that many clients don't need, and which cause overpricing. As just one example, most insurers set their excesses at very low levels, when in practice it is often not worth making a claim for a small amount. If insurers offered the choice (not the compulsion) of considerably higher excesses, it could be beneficial to both the insurer and the client, by reducing claims processing costs and premiums.

The problems above could be partly to blame for the problem of under— insurance in Australia, both for life and housing/ contents cover. "Unfair terms" legislation should be extended to insurance; it is unacceptable that consumers must first suffer harm and need to go to court for restitution.

4.4. create an environment conducive to dynamic and innovative financial service providers

Such objectives must be balanced with consumer safety, appropriateness and the level of public financial literacy.

4.5. *relate to other matters that fall within these terms of reference*

Class actions and the role of litigation funders should be examined. We believe that it is appropriate to permit class actions by customers against supplier companies, banks etc, and their auditors and directors — but the use of class actions by shareholders against their own companies (and hence against their fellow shareholders) is bad policy. It effectively means that one group of shareholders is attacking the balance of shareholders, who may already have suffered from the same loss that the litigants are complaining about — and who were not responsible for that loss. We believe that the law should be changed so that shareholders can sue only directors and executives (and their insurers and auditors), not the company itself. These points apply irrespective of how the action is funded, but the development of litigation funding in Australia has led to an increase in expensive shareholder-led class actions, which is detrimental to the investment sector as a whole and arguably does not stimulate improved governance.

5. *The Inquiry will take account of the regulation of the general operation of companies and trusts to the extent this impinges on the efficiency and effective allocation of capital within the financial system*

As a general principle, regulations and governance rules should be harmonised as far as practicable across the different financial product providers to the public. For example, companies, managed funds, corporate and industry super funds, trusts etc, should all be subject to similar and at least "adequate" standards of governance and reporting. The fiduciary responsibilities owed to public companies by their directors should be replicated in other existing and emerging organisational structures. Disclosure and reporting requirements for managed funds should be as extensive as those of listed companies. However, the costs of complying with further regulation need to be considered versus the potential benefits (financial or qualitative) to the end investor.

We are concerned with other market practices which benefit institutional investors and disadvantage retail investors. The current regulations should be strengthened so that the interests of retail shareholders are given due importance and regard by directors of entities or promoters of financial products. Regulations requiring pari-passu treatment of non-institutional shareholders versus institutional shareholders would be welcomed, for example in issuing new capital, providing updates and briefings (as noted in ASA's Policy Paper) — see Sections 5g and 5h below.

A major problem in western financial markets is the pervasive tendency to short-termism. This has widespread effects: in management of investment portfolios (particularly in equities) where performance pay seems to be determined more by comparing returns with peers than with absolute returns; in companies, which are impelled to consider likely shorter term effects on their share prices even to the detriment of long-term decision making, for example, for capital investment and R&D, where substantial investment could come at a short-term cost to profitability and return on capital, but generate excellent long-term returns; and executives tend to be motivated to receive nearly all of their remuneration over a two or three-year time frame, rather than the five years or more that are appropriate for major strategy and investment decisions. This will need a wholesale change of attitude throughout the financial system — but it is a fundamental impetus in ASA's drive for longer long-term incentive(LTI) vesting periods in executive remuneration packages, and for boards and executives to build up significant shareholdings in their companies.

ASA offers the following specific observations:

a) We have significant concerns over the quantum of aggregate remuneration paid to executives of larger listed companies. The increases in overall levels of remuneration occurring in the last two decades have had and are having inflationary effects upon the economy and destabilising effects upon employment and productivity. After annual report disclosure changes took effect in 2007, we suspect that there is a form of competition between executives as to who can achieve the highest disclosed remuneration under the various categories such as fixed salary, short-term incentives (STIs) and LTIs, contrary perhaps to the intended effect of such changes in dampening the level of executive remuneration increases. We believe that incentive pay, which was introduced to Australian companies in the 1990's, is behind much of the increase in executive remuneration. In a sample of 30 listed companies (which excluded banks) for 2013, aggregate remuneration of their CEOs totalled $125.94 million, of which 60% was incentive pay. The CFOs' remuneration of the same 30 companies totalled $44.9 million, of which 51.2% was incentive pay. In another sample of 10 WA listed companies, total reported remuneration of directors and key management increased from $54.8 million in 2007 to $99.7 million in 2013, an average compound annual increase of 10.49% compared to the all-cities CPI of 2.68% (that is, four-times CPI). Our analysis of these 10 companies shows that (on average) non-executive directors' pay (this being subject to shareholder approval) increased 3.4% p.a, whereas CEO pay increased 13.1% p.a, and average non-CEO executive pay increased 11.9% p.a. — executive pay is not subject to shareholder approval. There are of course a multitude of reasons for these companies to have increased total disclosed remuneration and CEO remuneration above CPI, including their profitability (being WA companies, many have some involvement in extractive industries) and expansion of activities through acquisition or into new fields. However, ASA remains concerned that the total remuneration levels are driving inflationary wage demands throughout industry. We also worry that high levels of incentive pay have a negative effect on the performance of subordinate employees — whilst some are motivated initially to work hard to achieve executive levels where these incentives are applied, others are concerned about the inequity of their bosses earning many times their level of pay and are negatively motivated to improve their performance. We recommend consideration be given to legislative measures to restrain executive remuneration including capping total incentive pay, such that the combined maximum potential STI and LTI, when granted (calculated at full value in accordance with our comments in Section 5f below) should be no more than 100% of annual "fixed/base" salary.

b) Listed trusts such as REITs and managed funds in which superannuation funds are held (such as those administered by bank subsidiaries) are regulated under the Managed Investment provisions of the Corporations Act. These provisions provide little opportunity for the holders of managed units to provide input on management and governance issues, because the control of these funds rests with management companies which are not regulated in the same manner as listed companies. We would like to see these management companies (REs) subject to the same degree of investor control as listed companies; the Corporations Act should be amended to require such entities to hold annual general meetings, to provide two-way investor engagement even if there are no other formal resolutions, and at which directors are elected by holders of units in their managed investments. This stark difference between requirements for trusts and companies is unacceptable — it puts form over substance. As just one example of this lack of accountability, the listed Rubicon and Record Realty property trusts raised over $1 billion of equity from the public and went into liquidation some five years later — with total loss of their equity capital and material debt write-offs — without once holding a meeting with their retail investors. Trusts and REs should disclose management remuneration to the same extent as listed companies. We would also like to see additional regulation making them accountable to unit holders for voting undertaken (or not) on their behalf at meetings of entities in which the trusts/RE invest, so as to be transparent to the underlying investors in the trust. See also Section 3.5.

c) We believe that the Government's stated plan to relax financial advisers' duty to put their clients' interests first is a retrograde step. It is critical to the workings of the financial system that trust in financial advisers be restored. We suspect that lobbying by large financial institutions, which employ large numbers of financial advisers in their managed investment subsidiaries, and minimal consultation with retail consumers in this system, have led to the Government's position as above. Adequate consideration has not been given to the economic consequences for a country with an ageing population increasingly reliant on superannuation savings, much of which is effectively controlled by these financial advisers. We see the growth of self-managed superannuation as a prime result of widespread distrust of the financial services industry, even though it may create the undesirable consequence that the investment activities conducted by some SMSF trustees may be inherently more risky than institutional management.

d) It should be a requirement for listed entities to disclose direct or indirect political donations in their annual reports, to deter those entities from attempting to influence government policies through political donations. This is not a matter for accounting standards, a point perhaps overlooked in the 1990's when "black-letter" law requiring such disclosure was repealed in favour of requiring annual financial reports to comply with accounting standards. In a similar vein, although this is more a matter of good governance and environmental social governance (ESG) reporting, listed entities should be encouraged to make full disclosure of their charitable donations in their annual reports; even though these do not have the potential for corruption that is a hazard with political donations, they are still a distribution of shareholders' money, and shareholders are entitled to know the (material) amounts and recipients. We would also like listed entities to ascertain their top 20 beneficial shareholders, as well as the legal holders, and for that information to be published at the same time as the standard "top 20" in the annual report.

e) We are concerned with the level of short-selling undertaken — ASX daily reports show many stocks where short positions exceed 10% of the total shares on issue. Whilst some level of short-selling is perhaps desirable, we are not convinced of the rationale in allowing any such activity to occur. We understand that short-selling (which is a trading tactic unavailable to most retail investors due to broker restrictions) is facilitated on an institutional basis by managed funds "lending" their shareholdings to hedge funds and other entities engaged in short-selling activities. Managed funds hold their investments in trust for their unit-holders who are indirect retail investors, in the main. It seems to be an abrogation of that trust to lend fund assets to third parties, in any circumstances. It also seems to be counterproductive; the fees earned for lending stock are unlikely to compensate for the downward pressure imposed on the share price by the short-selling of that stock. For similar reasons, we believe that "vote renting" should be prohibited for the stock of all listed entities.

We recommend that these practices should be outlawed for any managed fund, with directors of responsible entities in breach of such laws being subject to severe penalties including imprisonment.

f) We have noted a practice by some listed entities of pricing shares (or similar equity interests) proposed to be issued to executives under incentive plans at a material discount to market values, using option pricing techniques to purport to establish a so called "fair value" of the securities or rights to be granted. By way of example, assume that an executive is to be allocated up to $200,000 worth of shares as a long-term incentive, with proportionate entitlement to be established at a vesting point three or more years after allocation, based on achievement of performance hurdles; that is, the executive might get all, some or none of the shares depending on performance. If the market value of the shares at the allocation date is $10 per share, we would expect to see the entitlement to shares established at 20,000 shares. Our concern is the practice developing of discounting the current market value for the risk that the shares may not vest or that the market value may change in future; the use of option pricing models that purport to determine that the current "fair" value of the share/right is only (say) $5 per share, would "justify" the board allocating an entitlement of 40,000 shares on that basis. We frequently see cases of the potential award being double the stated value, and sometimes even triple. We believe that this "grossing up" practice should be outlawed as it is equivalent to hedging the risks of corporate and personal non-performance, which is specifically prohibited under Corporations Law. It is also misleading to shareholders, especially so when the grant is being voted upon pursuant to ASX Listing Rule 10.14*. Spurious reasons are given to support this practice; it must be emphasised that these are incentives, on top of what is usually very substantial fixed pay which is certain to be received in full. *(In passing we note the anomaly that securities awarded to directors and their related parties do not require shareholder approval if they are purchased on-market, as opposed to a new issue — as a matter of good governance many companies choose to put it to a shareholder vote anyway, but the anomaly should be removed.)

We recommend that the law be amended to state that it is illegal to allocate or issue shares or other equity rights to executives or directors at a price less than current market value unless it is part of a proportionate offer to all shareholders. At the least, if a board wants to make such a grant to its executives, it should state the full undiscounted market value of the total grant at the date of grant /AGM notice of meeting and in subsequent annual report(s).

Directors and executives should be prohibited from underwriting capital raisings (whether to earn fees or acquire equity at below market price): they should only be able to participate in an issue on the same terms as the other shareholders. Subject to this "equal access" requirement, we do encourage all key management personnel (including non-executive directors (NEDs)) to acquire material holdings in their companies.

g) There should be a level playing field for all investors and we recommend that the following aspects of market activities be reformed:

i. In capital raisings, many countries insist that any new shares be offered to existing shareholders proportionately before being placed to brokers' institutional clients etc. Australian laws facilitate placements which are often to the detriment of retail shareholders. In the aftermath of the GFC, banks and other corporates offered new shares on a deeply discounted basis to secure additional capital, diluting existing retail shareholders who were unable or unwilling to take up the new equity. In many cases the total allocation (if any) to retail investors was severely limited, despite the retail component being heavily oversubscribed. The modern trend to make such offerings through an institutional bookbuild, followed by a retail share purchase plan with entitlements capped (by the ASIC Class Order) at $15,000 per investor prevents a proportionate allocation even if all shareholders are willing to take up their entitlements and/or any shortfall in other shareholders' entitlements. To impose a scale-back as well as the $15,000 Class Order limit creates a double restriction. We appreciate that our preferred principle of fairness may restrict the ability of small companies to raise capital, but having approximately 2,000 listed companies, of which the majority are very small and illiquid, is not in the best interests of investors either.

   We strongly favour renounceable rights issues as the fairest method of capital raisings, with the shortfall either being sold for the benefit of non-participating investors (although see Section 6 below on the tax disadvantages) or able to be bid for as "overs" by all existing shareholders who want to take up more than their full rights allocation. Attachment A outlines the ASA policy position on capital raisings.

   We oppose the 2012 change to the ASX Listing Rules that allows up to 25% of a smaller entity's capital to be raised in placements each year—a magnification of the principle that we already dislike with the 15% p.a. standard limit. It is unfortunate that in over 600 cases shareholders have voted to approve this 25% rule for their companies; that is, they voted in favour of the potential for themselves to be diluted even more than under the already unsatisfactory 15% p.a. placement rule.

ii. We understand that the ASX has permitted trading houses to site their computer equipment within the ASX's premises so as to minimise delays in the flow of announcements, lodgement of bids and completion of trades. Retail shareholders and traders are unable to have such facilities and we believe that no entity should receive such preferential treatment. We understand that the NYSE requires trading and broking entities' computers to be connected via cables of a minimum length so as to prevent any such favouritism.

iii. Trading and broking entities should not be allowed to operate "dark pools" for trading clients' shares. All trades of client shares should be processed through the ASX or Chi-X themselves so that transparency is achieved. A copy of the submission that ASA made on High Frequency Trading to ASIC is included as an attachment (Attachment B) to this FSI submission.

iv. We believe that the law should prevent broking houses and other market participants from discriminating between clients as to trading terms and conditions — a single set of published rules by each broker should govern such matters as short-selling restrictions, lowball bids, minimum trades and marketable parcels.

v. We think that investors should not be able to subscribe for an information service that provides access to information to be released to the ASX before all market participants have access to it.

h) We have made submissions to the CAMAC inquiry into annual meetings to support the continuation of AGMs in their current form (with some improvements) as the only public opportunity for retail shareholders to question and express their opinions about management's actions, and hold boards and senior management to account. We have recommended that a combination of online direct voting and proxy voting be continued, with voting on a show of hands to be discontinued as it is undemocratic and often leads to shareholders being intimidated from registering their vote.

6. The Inquiry will examine the taxation of financial arrangements, products or institutions to the extent these impinge on the efficient and effective allocation of capital by the financial system, and provide observations that could inform the Tax White Paper.

ASA offers the following observations:

a) The current predicament faced in Australia is that of an ageing population supported by a domestic economy losing jobs to countries with cheaper labour and energy costs; this creates the prospect that the retirement standards of today will become the responsibility of a shrinking workforce and become unsustainable at some point in time. Contributions to superannuation funds have been controlled by caps for some years, but a period existed when there was no effective cap on individuals' ability to contribute to or transfer assets into superannuation funds, where they enjoy significant taxation concessions. Political parties have been reluctant to amend these taxation concessions for fear of a backlash in the polls, but it is time to consider whether it is fair that those who were in a position to take advantage of the period before contribution caps were introduced may continue to enjoy the benefits, to the detriment of other retirees supported by state pensions. We think that a system of taxing the withdrawal (either as pensions or lump sums) of superannuation funds by those of pensionable age should be reintroduced for amounts in excess of a level deemed to provide a comfortable retirement income. We also believe that the arbitrage benefits for higher rate tax payers to claim deductions for super fund contributions should be reduced or removed, and incentives for low income earners to contribute to super should be made more attractive.

b) It is concerning that some superannuants are being beguiled into investing their superannuation funds into geared real estate — such superannuants are generally SMSF trustees regulated by the ATO, hence our inclusion of this topic under this heading in the TR. The concerns we have are those of putting too many eggs into a single basket, the illiquid nature of such investments, inappropriate marketing and/or overpriced properties, and the greater risk assumed through gearing investments. We recommend that the Government should look at introducing more restrictions on the ability of superannuation funds to incur borrowings (for example, by imposing percentage gearing limits, subject to annual audit) to mitigate investors' risks of such losses. We also note that real estate agents need no training or qualifications in financial advisory skills to propose purchases to SMSF trustees (unlike financial advisers) and that this situation adds further risk (and conflict of interest) for SMSFs contemplating investing in real estate. As a wider observation, the overall effect of negative-gearing is that housing investment (or property more broadly) is preferred by many taxpayers over other forms of investment, with a distorting and inflationary effect on the prices of existing housing and reduction in capital available for more productive uses: this aspect of the effects of taxation policy on economic activity needs review.

c) A welcome development in equity markets is the sale, on shareholders' behalf, of rights not taken up by shareholders, with the proceeds being remitted to them. Unfortunately, the ATO treats these payments as unfranked dividends and taxes the full amount as income; many commentators consider this to be incorrect, since the commercial effect is merely compensation for the dilution of their existing investment — and is akin to a return of capital, so should be treated as a reduction of the cost base for CGT purposes. The current ATO treatment means that investors not only lose the benefit of the 50% CGT discount in respect of the payment, but also pay tax in advance instead of when a genuine capital gain is made. The law should be amended to reinstate the treatment as capital return.

d) Some smaller listed companies and trusts with limited capital partly remunerate their staff with options to reduce the cash cost of employment. The current treatment of taxing these upon grant rather than when or if exercised makes them unattractive, and arguably unfair, as a means of remuneration and incentive. We suggest that the Inquiry consider whether this treatment can be better harmonised with the taxation of other forms of remuneration (subject to some caps to prevent abuse).

e) There is much public concern about the apparently very low effective rates of tax paid by some multinational groups, especially those that provide services rather than goods, on their profits that arise from conducting business in Australia and/or supplying services to Australians. Although we recognise that this is a very complex field, there would be merit in tougher investigation of transfer pricing, especially based on intellectual property. Government should also consider renegotiation of tax treaties, in conjunction with other OECD countries, to remove the benefits of artificial structuring using low tax countries and tax havens.

f) Negative gearing and the CGT exemption for owner-occupied housing cause distortion in the allocation of capital from more productive investment. In a similar way, the combined incidence of tax and inflation erodes the real after-tax yield on savings deposits and government bonds to negligible (sometimes negative) levels. We suggest that the Inquiry consider Government issues of either nominal or inflation-linked bonds, where only the real return over the CPI is taxed. This would surely be attractive to conservative savers; it might need to be restricted to natural persons and subject to a limit (perhaps $500,000) to avoid crowding out by very wealthy investors and institutions. A similar CPI-tax advantaged bond could be considered to raise very long-term funding for infrastructure investments; the flaws in the earlier generation of infrastructure bonds would need to be removed.

The Inquiry could consider the benefit to the economy of increasing the rate of GST to say 15%, and removing all exemptions (with suitable, but separate, income support or credits where necessary to prevent hardship), to fund a more equitable spread of the tax burden between consumption, income and capital.

6. *In reaching its conclusions, the Inquiry will take account of, but not make recommendations on the objectives and procedures of the Reserve Bank in its conduct of monetary policy.*
7. *The Inquiry may invite submissions and seek information from any persons or bodies.*
8. *The Inquiry will consult extensively both domestically and globally. It will publish an interim report in mid-2014 setting out initial findings and seek public feedback. A final report is to be provided to the Treasurer by November 2014.*

I acknowledge the significant contribution to this submission by my colleagues Richard Wilkins, John Campbell and Diana D'Ambra.

Ian Curry
Chairman

ATTACHMENT A: CAPITAL MANAGEMENT

1. Treating all shareholders equitably

When raising capital, devising dividend policy or considering other capital management issues such as buybacks, directors must always strive to treat shareholders as equitably as possible, including minority shareholders, retail investors, institutions, directors, executives, staff and foreign investors.

2. Dividend policy

ASA dividend policy is for a majority of distributable earnings to be paid to shareholders as dividends. Boards should have a clear and consistent policy in this regard. Where franking credits have been generated, ASA believes public companies should strive to distribute as many of these as possible to Australian resident shareholders within the constraints of the company's balance sheet and cash requirements for investment. Residual franking credits held after the final dividend has been paid should also be routinely disclosed in the 5 year summary contained in the annual report. Dividend Reinvestment Plans are appropriate when companies need to retain some earnings and can come with an appropriately modest discount to volume weighted average price (VWAP) formula in order to encourage participation.

3. Respecting the property rights of shareholders

All shareholders are entitled to be able to retain their percentage holding in an ASX-listed company without being diluted or squeezed out through a capital raising. This is a fundamental property right too often ignored under Australia's highly flexible capital raising rules. When raising capital, companies should do so on a pro-rata basis to all shareholders with the ability for non-participants to be compensated through a single bookbuild if they renounce their entitlement.

4. Selective placements

ASA is opposed to selective institutional placements as these do not respect the property rights of existing shareholders to retain their proportionate stake in the company. The reason for any placement should be clearly explained to retail investors. The introduction of a new strategic cornerstone investor can be secured through a placement, but only if there is a compelling commercial argument. Such issues should be priced above the prevailing market price and should not surrender the ability of shareholders to receive a subsequent change of control premium.

5. Share purchase plans

Boards must offer retail investors a Share Purchase Plan after any selective placement, on the same or better terms than the institutional offer. Individual shareholders should be offered the maximum $15,000 investment. Participation will always be stronger and applications will arrive earlier if there is discount to Volume Weighted Average Price (VWAP) formula in addition to any fixed price component. If the size of the SPP is to be capped, it should reflect the percentage of the register owned by retail investors (ie if a company is seeking to raise $100 million and retail investors collectively own 40%, it should be a $60 million placement and a $40 million SPP) to minimise the prospect of retail investors being diluted as a class.

6. Renounceable pro-rata entitlement offers

ASA policy for raising capital is to use pro-rata renounceable entitlement offers as this method treats all shareholders equally and avoids any dilution for investors who choose to participate. The form of renounceability is important. On-market "rights" trading is in decline but still should be offered where practicable. In order to maximise compensation for non-participants, a single bookbuild combining the institutional and retail shortfall should be conducted at the conclusion of the offer. Market practice has shown that earlier institutional bookbuilds where the offer is accelerated, tends to deliver higher returns than retail investors receive in any later offer. Therefore, ASA does not support separate bookbuilds.

7. ASA response to unfair capital raising structures

ASA notes that retail investors were diluted out of more than $10 billion worth of value during the raft of capital raisings which occurred in the immediate aftermath of the global financial crisis. The primary causes were discounted institutional placements with no follow-up SPP, unfairly restricted SPPs, a lack of renounceability in entitlement offers, separate bookbuilds to deal with institutional and retail shortfalls and poorly marketed retail offers and limits on the ability of shareholders to apply for additional shares in entitlement offers. Having learnt all these lessons and with corporate balance sheets now rebuilt, ASA is concerned about ongoing unfair treatment of retail investors in capital raisings. When this occurs, ASA will consider opposing incumbent directors seeking re-election at the next AGM. In particularly egregious cases, ASA will consider supporting alternative candidates for the board if they are committed to the fair treatment of retail investors in capital raisings.

8. Non-renounceable entitlement offers

Non-renounceable offers have declined in recent years but they are still preferable to institutional placements. However, if an offer is to be non-renounceable, retail investors should be able to make unlimited applications for “overs” or “additional shares” to take up any lapsed entitlements from other retail investors. This facility minimises the dilution of retail shareholders as a class.

9. Disclosure of allocation and scale-back policy

When raising capital through an SPP or entitlement offer with “overs”, the documentation should clearly enunciate any scale-back policy which will apply in the event of applications exceeding the new shares which are available. And when disclosing the outcome of such offers, boards should clearly explain the scale-back formula including disclosures such as the number of shareholders who participated and the amounts allocated to “overs”. ASA requires a scale back formula which reflects the size of a shareholder’s existing holding, rather than the size of any application for new shares. Therefore, larger retail investors should receive larger numbers of additional shares than someone with an unmarketable parcel. However, there is also merit in allowing the smallest investors to lift their holding to the marketable parcel threshold of $500 as a base case where “overs” or SPP applications are being scaled back.

10. Disclosure of fees paid when raising capital

ASX listed companies have paid excessive fees when raising capital in recent years, often with poor disclosure. Any agreements with investment banks or under-writers should be fully disclosed to the market at the time of the capital raising announcement. This disclosure should include the total dollar figure in costs, the percentage or fixed fees to be paid for each component of the capital raising and the total costs as a percentage of the funds raised.

11. ASX onmarket bookbuilds

ASA is a public supporter of the new ASX Onmarket Bookbuilds service as it uses technology to potentially lower the cost of raising capital and makes the capital raising process fairer and more transparent. Companies which use this service should be able to save on fees to intermediaries and also offer new shares to a wider pool of investors, including eligible retail investors once the system is better understood and more established. There is merit in exploring legislative reform which facilitates direct retail participation in bookbuilds associated with capital raisings

12. Communicating with shareholders when raising capital

Retail investors often don’t act in their best interests when presented with an attractive in-the-money capital raising opportunity. Therefore, companies are encouraged to actively market such offers to small investors. A good example is the sending of a reminder email shortly before the offer closes. Similarly, boards should consider taking out newspaper advertisements, issuing press releases or engaging with prominent private client retail brokers if there are early signs that an in-the-money retail offer won't be fully subscribed.

13. Managing un-marketable parcels

Companies are quite within their rights to manage down the size of their share register, especially after demergers or takeovers which create large numbers of holders with unmarketable parcels. It is also acceptable for the default position to be that those who do nothing have their shares sold. However, the document advising of this which is sent to holders with parcels worth less than $500 should always include a reply paid envelope to make it easier for small investors to retain their shares. This is especially the case with poorly performing companies which have created unmarketable parcels through value destruction and may have shareholders who wish to take tax losses at a time of their choosing.

ATTACHMENT B: ASA Submission on Dark Liquidity and High Frequency Trading
ASIC 18 March Report and Consultation Paper 202

6 May 2013

Background

The Australian Shareholders' Association (ASA) represents its members to promote and safeguard their interests in the Australian equity capital markets. The ASA is an independent not-for-profit organization funded by and operating in the interests of its members, primarily individual and retail investors, self-managed superannuation fund (SMSF) trustees and investors generally seeking ASA's representation and support. ASA also represents those investors and shareholders who are not members but follow the ASA through various means, as our relevance extends to the broader investment community.

This submission is a response to the ASIC report and paper. We note the conclusions drawn from submissions received by ASIC and wish to present information, examples and suggestions for further consideration and to ensure that retail shareholders are protected in an investing climate that is fairer for all participants.

ASA believes that restricting dark pool trades to a minimum size threshold will prevent retail shareholders from taking part in cross trades which typically are undertaken with their own broker. There are advantages for those involved in these trades. There is certainty of the trade rather than the client being placed at the back of a queue. Brokerage is cheaper as a rule as the broker is on both sides of the transaction and does not have to pay ASX for the use of the market.

In recent years dark pool trades, which are identified by the condition XT, have grown considerably and are now at a level which undermines confidence in the market. The proposal by ASIC suggests that big traders will be allowed to continue as now while small investors will be excluded.

Cross trades no longer appear to be just a trade between clients within the same broker. Large market participants have created their own pools. It is not appropriate for a principal, who controls the trade, to take part in a crossing particularly if the party on the other side of the trade has no knowledge of this.

We appreciate that Dark Pool trading is part of a complex problem and we would like to see ASIC do what it can to make the system fairer and more open without making retail traders the scapegoats. All investors must get the best price available.

In regard to tick sizes, ASIC is suggesting changes to stocks in the range \$2 to \$5. Thirty six stocks are shown on Commsec as last trading at 0.1 cents and the tick size there is 100 percent between \$0.001 and \$0.002. More than half the stocks on the ASX markets trade at less than 30 cents and we believe this is the area that needs attention. If a stock is trading at 10c or more, the minimum tick size is 0.5 cents and at that price, it represents 5 percent of the share price which is too large. Such a large tick percentage encourages Centre Point trading, and in the opening and closing auctions, it encourages HFT's to control the price and decide whether they want to be the buyer or the seller in the milliseconds before the auction ends. If the tick size is made much smaller in this range of prices, there will be much less gain to be made from manipulation or from unfair HFT speed advantage.

The ASA does not have access to High Frequency algorithms or trading so we can only see what is happening on the markets from our own retail position. The underlying concern of many of our members is that we no longer have a market operating as a level playing field and that there are several situations where there appears to be one set of rules for large investment bodies (including High Frequency Traders) and another for retail investors.

In section E of document CP 202, ASIC puts questions about small orders not being able to be withdrawn within 500 milliseconds. Unless it is a clearly mistaken order, we believe that no orders should be put in and withdrawn that quickly, not just small ones, and we also believe that orders below $500 should not be allowed at all unless it is the full holding of a seller. The number of small trades taking place in recent times has changed the market enormously. As one example of this, a large well known trader recently advised the market that it had become a substantial shareholder of Cabcharge (see http://www.asx.com.au/asx/statistics/announcements.do?by=asxCode&asxCode=cab&timeframe=D&period=W). Cabcharge is not a particularly large company with a market capitalisation of $576 million. In less than four months this trader did approximately 3,600 trades in Cabcharge as shown at the end of that announcement. How many bids did the trader actually put into the system if that number of trades took place. What was the effect that these transactions had in terms of brokerage, volatility and gains/losses for those on the other side of the trades. In our view, transactions of that frequency are not passive and have taken control of the process.

While the very large order to trade ratios of HFTs is a concern, it is the quality of those orders which seems even more relevant. As an example, after the close of trading on April 23rd, the highest Lynas seller was seeking 77.5c compared to a last sale price of 48c. Just prior to the start of trading on April 24, there were 43 new sellers seeking prices from 78c to $3.60. After the close, the largest seller was 77.5c again. This happens frequently at the start and end of the Lynas market. Is the point of these offers an attempt to make the selling volume look heavier than the buying. This may be manipulation. Trades at those prices have virtually no chance of taking place and they are removed at the end of each day and put in again the next morning. While ASA and its members are concerned about the large order to trade ratios, the quality of the trades is much more important – are they genuine or are they put into the market to mislead? In the above example, why is a “buyer” repeatedly putting in a bid at $3.60 for a share that last traded at 48 cents and why is it not being refused entry or questioned?

We certainly agree with ASIC in trying to clarify what constitutes manipulation and in bringing in rules to make it more difficult to do so. In section 154 of Consulting Paper 202, ASIC defines the terms Layering, Quote Stuffing, Quote Manipulation and Spoofing. We see these definitions as an explanation of High Frequency Trading itself. We can see no advantage for investors, public companies or Australia in allowing these trades to continue. Those advantaged are the Stock Exchanges, ASX and Chi-X, and the High Frequency traders themselves.

ASA and its members seek the removal of algorithmic computers from the ASX trading floor and for regulators to make entry times as equal as possible for all market participants. Alternatively, remove the auctions and the arbitrage that gives HFTs, and others, unfair advantage.

Apart from the issues that ASIC has raised in its Consultation Paper and its March Report, there are several related issues which concern the ASA and our members and we would like them to be considered:

In its last annual report, ASX's Managing Director reported that revenue from Technical Services was larger than revenue received from Cash Market Trading. We believe there are strong signs that suggest unfair advantage may have been created for those who pay ASX directly for products or information.

Here are some features of the market that our members see as unfair.

> * Some of the larger investors, (e.g. clients of Iress), obtain market sensitive announcements before ordinary investors who access the announcements on the ASX website. You can read the document on Iress, go to ASX and request the same document and regularly get the message "This document is being processed". If ASX cannot provide these documents to the general market at that time, how does Iress get access to them? Clearly the longer period that ASX's paying customers have access to a price sensitive document before the general public gets access to it, the more valuable the information is and the more they are likely to pay ASX for it.
>
> * Important company information is released by Iress but not by ASX e.g. when trading ceases for 10 minutes because of the release of market sensitive information, Iress advises of this halt and of the time when trading resumes. ASX does not tell the general public of these short trading halts at all, yet we presume that it has advised paying customers of the time schedules. Also when companies are out in trading halts for a longer period e.g. several days, Iress advises the exact time that the trading halt will be lifted. The ASX does not.
>
> **** Iress advises its customers of all the stocks that have gone ex dividend. Presumably Iress gets this information from the ASX but it is much more difficult for retail investors to find this information on the ASX site or on many of the broker sites.
>
> * Retail investors are generally required by their brokers to limit orders to marketable (minimum) parcels whereas HFT traders and other large investors have no such restriction. The ASX does not have a minimum limit on trade size. There are a huge number of unmarketable trades going through the market.
>
> * The ability of HFT traders to place and withdraw trades within milliseconds, the use of trading algorithms, the introduction of exchange competition via Chi X and Dark Pool Trading gives HFT's the ability to "read" other market orders before they reach the markets and thus provides them with the opportunity to beat them to the trade. We have seen examples where large bids put in by our members have been beaten into the market at the same price by a fraction of a second and we suspect that this is due to those original bids being hawked around the dark pools and the different markets before going into the formal ASX market. It does appear that High Frequency traders do see large bids coming and can beat them into the open market at the same price.
>
> * Retail shareholders can be charged for full trade brokerage triggered by an HFT probing the market with minute parcels e.g. when a Commsec order triggers a $19.95 minimum

commission for the purchase of 2 shares even though the order may have been for 100,000 shares and the balance of the order may never be fulfilled.

* Pre-opening and post-close trading takes place and is not accessible to retail shareholders.

* The opening and closing auctions provide a large portion of the market turnover and since the introduction of HFTs and algorithmic trading, those auctions provide unfair competition for retail traders. High Frequency Traders can and do change their bids within a fraction of a second to react to retail bids which generally take many seconds for the manual investor. Those retail shareholders who are not live traders are unaware of this.

The formula for the final auction share price is quite complex. The details are available at http://www.asx.com.au/products/calculate-open-close-prices.htm An example of how it is used by HFTs, is shown in the following situation:

Buyer's volume	Buyer's Price	Seller's Price	Seller's Volume
100000	10c	10c	100000

At the close of the auction the deal would go through at 10c. But say another bidder puts in a buying bid as follows:

Buyers volume	Buyers Price	Sellers Price	Sellers Volume
99,999	10.5c		
100,000	10c	10c	100000

Because the new bidder's volume is lower than the seller, he will get the shares at the seller's price of 10c and the original bidder ends up with 1 share at 10c and a full brokerage. If any one of these traders is a High Frequency Trader then he could alter the final result to suit himself. For example if it is the seller he can very quickly change his price to 10.5c and then the deal goes through at 10.5c. Small shareholders who don't trade live, don't even see what is happening and those who do trade live cannot compete against a competitor who can respond in milliseconds.

* There have been several new market services such as Centre Point trading and Iceberg orders which are not available to retail investors. Centre Point trades allow large investors to go ahead of the queue at prices that are not available to retail investors. For example if a stock has a highest buyer at 10c and a lowest seller at 10.5c, a retail investor cannot bid inside this range but centre point trades go through at the midpoint of 10.25c.

Conclusion

ASA believes the following issues need to be addressed:

1. If ASX is selling price sensitive information to companies such as Iress it should be compelled to release this information to all interested parties at the same time.

2. All participants should have access to details of when companies are halted from trading due to market sensitive information and advised when trading will resume. Iress supplies this information to its customers but the ASX does not release it to the general public.

Items 1 and 2 lead us to believe that there is a case for a government body such as ASIC to take charge of receiving and publishing company statements and ensuring that they are made available to all participants at the same time. If this is not possible then ASX must be required to do so.

3. Minute sized bids should not be allowed. Either introduce a charge on every trade or market bid, or disallow bids that are not of a reasonable size such as a marketable parcel. This seems a simple way to prevent claims of market manipulation.

4. High frequency traders and others should not be allowed to manipulate auction prices in the opening and closing markets. Bids are removed and altered in the final seconds in a way that is totally inequitable to retail and institutional shareholders. The investors at the top of the queue at the start of the auction frequently end up buying or selling 1 or 2 shares while the bulk of the sales go to those able to dictate the final price and the buyer. Unless the opening and closing auctions are transparent, they should be removed. Retail shareholders cannot compete in the current circumstances.

5. If these small orders are allowed to continue, disallow or discourage brokers from charging full brokerage on a normal marketable bid when only a miniscule portion is obtained.

6. Disallow or discourage brokers from charging full brokerage for an internal dark pool trade. The broker gets the brokerage from both the buyer and the seller and does not have to pay ASX anything for the trade. Investors should be informed when some of their contract has been achieved via a cross trade.

7. Centre Point trading appears to be a method of allowing large shareholders and High Frequency Traders to gain an advantage. Some of our members have tried to take part in centre point trades and been unable to do so. It is not at all clear who can take part in these trades.

8. No information or advantageous methods of trading should be available to one group and disallowed to others.

At the present time we believe the market is not a level playing field for retail investors and we ask ASIC to examine and rectify the matters we have raised.

ASA acknowledges the valuable contribution by the Chairman of ASIC during his presentation at our conference held in early May. This has provided more information on this difficult subject. However we believe our comments require further examination.

Yours sincerely

Ian Curry
Chairman