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Financial System Inquiry
GPO Box 89
SYDNEY NSW 2001

To Whom It May Concern:

Financial System Inquiry – Submission

Please find herewith submission which addresses particular terms of reference as outlined for the Financial Systems Inquiry.

1.3 Availability of financial services, products and capital for users

Remuneration

The Storm Financial example led regulators and the then government to the view that financial advisers should not be remunerated based on percentage of assets. In our view this is an erroneous conclusion. It was not the percentage of assets that was the problem. It was they were charging 5-7%, and that number is too high. A number in the range of under 1.0% is the norm.

The financial regulation also adversely impacted on financial advisers. The investment managers such as Perpetual, AMP and Colonial were not at any time challenged that they should not charge a percentage of funds under management for their services.

Your diarist submits rather than charge only brokerage on transactions, a far better model is to charge a small percentage based on funds under advice with a smaller brokerage amount as this aligns the interests of the adviser and the client to increase those funds over time. This is certainly the model our firm has utilised for many years. This argument was eventually accepted by the then Government and so this an argument for the status quo per FOFA.

Conflicts of interest

A far more important area to be considered are conflicts of interest. In the USA the Sarbanes-Oxley Acts meant that broking firms could not act on behalf of corporations raising funds, issue research and then use that research to convince retail investors to subscribe into IPO's, placements and other capital raisings of that firms clients. In Australia this has not occurred, whereas in fact it should. The introduction by the ASX of a book build process should be encouraged to satisfy governance in the raising of funds and also, overcoming conflict that merchant banks have a large incentive to allocate discounted placements to their clients rather than to follow the pari passu rule and treat retail investors and in fact all investors so they are not diluted. Given continuous disclosure for listed entities, it should be possible to further relax product disclosure statement requirements for new capital raisings in a continuously disclosing entity.

Recommendation: That PDS requirements for continuously disclosing entities listed on recognised stock exchanges be reviewed with a view to further reducing such requirements, so as to reduce costs of capital raising and to enhance non-dilution of existing shareholders by the making issues to existing shareholders in preference to placements to selected institutional wholesale investors at discounted prices.

Dividend Imputation

Refer to 6.0 below.

<u>2.3 Assessing the effectiveness and need for financial regulation</u>
<u>2.5 The role, objectives, funding and performance of financial regulators</u>

In 1976, your diarist attended and completed a business economics honours subject at the University of Queensland, Commerce Honours School with lecturer Allan Kledon. Allan subsequently completed a PhD at the University of Chicago and a teaching period as a Professor at Stanford, before going out into private practice. Two of the take-away's from the course were:

- Stigler's Theory of Regulation indicates there are competing bidders for regulation, including the regulators themselves and those, including politicians who see it as serving their political ends to increase regulation. There are also various professions who look for regulation to increase barriers to entry.
- The second take-away is that most regulation fails. Regulators and legislators set out with good intentions, but do-gooders often think they are solving one problem while the world of micro-economics gives them a different result.

Post the GFC, one would predict a large uptick in regulation as a result of failures during that period. There will of course always be failures of firms, as within any industry, there are good and profitable firms and average firms and marginal and failing/failed firms. That is simply the market at work.

Of more concern during the GFC, was that the stock markets had delivered such phenomenal returns over the period up to December 2007 that some firms and individuals were far too highly geared and ultimately paid the price.

The property trust section was the most dramatic with the index falling 2,400 to 600 i.e. by 75%. The sector was trading significantly above net assets at December 2007 (a sure sign of over valuation), the property trust industry was telling us how it was different this time because they had better management, a better use of debt (haha) or better development opportunities. Usually when someone tells you it's different this time, it's not. Moreover, several of the Australian firms were borrowing too short e.g. Centro and there was a lemming like rush to invest in the USA which turned out to be the top of their market also, but then the Australian firms managed to sell out at the bottom to realise the loss, just to rub salt into the wounds of Australian investors.

At the individual level, Storm Financial showed a financial planning firm that was double and triple gearing. This is of course a recipe for disaster as individuals should not double and triple gear. Triple gearing in this context refers to the fact that the underlying investments in companies and property trusts themselves are geared firms. So where there was a loan on a house and that in turn was used to buy investments which were then pledged into a margin loan and those investments themselves were corporations or property trusts that borrowed, then the level of gearing overall was very high.

The accounting profession may be trusted, but are generally not good investors. A distrust of markets and bias to top driven investments is common. The obscene amount invested in tree schemes on accountants advice was disgraceful.

What has subsequently happened is that there has been an enormous amount of regulation, which almost without exception has done nothing to solve the problem. Rather it has simply imposed costs on the remainder of the industry.

In the majority of cases, where people lose large amounts of money, there is either too much debt or they have invested too much money in the one investment. A deal of the FOFA regulation would be unnecessary and the government as proposed it be wound back. It is submitted that where a retail investor is intending to invest more than 10% of their assets in any one security or corporation or is intending to gear that investment so that total gearing would exceed 30% of total assets, then an independent report prepared by an ASIC licensed independent dealer would solve the problem. While there would be an additional cost, the reality is if this was prescribed in legislation, there would be a large disincentive for such investments to be made and this would be a great outcome for the Australian investing population.

Recommendation: Where 10% of a person's assets is being invested in any one security or corporation or that the level of gearing in respect of an investment is such that the total debt over total assets exceeds 30%, then an independent report is required from a licensed dealer, other than the dealer recommending the investment.

3.2 International integration

Financial Regulators - International Influences

Post the GFC, we've seen a push by regulators to act globally. Whilst this no doubt has some positive outcomes, for Australia is having increasingly negative outcomes. There is often a failure in Australia to understand how good our financial systems are e.g. the Australian CHESS system is by far the best holding system globally, yet you almost never see any one acknowledge that is the case.

Similarly the regulatory system in Australia during the GFC held up remarkably well, yet we've somewhat slavishly adopted the BASEL3 regulations. One downside to this for retail investors is that whereas in Europe and the USA, there is a well developed bond market, in Australia this is not the case. Many investors have been used to investing in hybrid securities such as CBA Pearls and ANZ preference shares. Under the old regulation, these securities were not overly risky, standing one or two steps to the right of term deposits. The new BASEL3 regulations are horrendous and a threat to the wealth of retail investors. The insertion of non-viability clauses at APRA's discretion and the ability to write-off the total raising in the event of some financial stress are beyond the contemplation of almost all retail investors. Yet APRA has sat back and slavishly allowed these BASEL3 regulations be imported into Australian listed hybrid securities.

More generally, there is an inclination to find levels of regulation overseas and simply adopt the highest level of regulation. For example, our firm spends an enormous amount of time identifying people we've known for many, many years. But apparently that is not good enough and we're now going to be subjected to the higher European measures designed to deal with tax havens. This involves with trusts, understanding who the beneficiaries are and with companies, identifying each of the directors. For a not-for-profit company with 12 directors, these requirements are simply ludicrious. The ID requirements, supposedly introduced as an anti-terrorism measure, cost our firm tens of thousands of dollars per annum. Yet I do not believe we've identified one terrorist.

Recommendation: That Australian regulators be more circumspect in adopting international regulations, particularly where the financial instruments are utilised in those jurisdictions are different and there is likely to be confusion in the minds of Australian retail investors.

Expatriates

Employees are becoming increasingly international. This includes Australian employees who increasingly become expatriates overseas. There is a real issue remitting superannuation back to Australia when an expatriate returns to retire to Australia or after an extended period overseas. The United Kingdom has led the way with the QROPS system under which a person emigrating or transferring residency to Australia is able to move their superannuation to Australia. One of the advantages is that by concentrating superannuation in the one fund with the one adviser is that it is likely to get a proper focus and retirement to be properly funded.

The QROPS legislation should act as a blue print for the United States and other major trading partners.

Recommendation: That the Australian Treasury group charged with the oversight of international treaties adopts as a key point the remission of superannuation between double treaty partners without penalty.

6.0 Taxation

Individual Taxation Threshold

The previous Labour Government increased the threshold before tax is payable from $6,000 to $18,000. It is submitted that this change is undesirable. It parallels the high threshold in Greece which partly led to the issues arising in that country during the GFC. It is submitted that where a young person first commences to undertake part-time work and there is a tax impost. he/she asks what this is for and is informed it is taxation to pay for the schools, roads etc. This contrasts to the Greek system where there is an entitlement mentality to not pay tax as it is only something for the rich.

The reality is with the demographics increasing towards retirement, that one can not afford the very young or the very old to not bear their share of taxation. Ultimately, the cost of the health system may mean an additional burden will be imposed on those who have retired.

Franking

The importance of the dividend imputation system and franking to the efficiency of the Australian economy and capital raising as well as corporate behaviour is relevant to section 1.3 above.

One of the reasons for the efficiency of the Australian corporates is the dividend imputation system, resulting as it does with an incentive for the company to pay its fair share of corporate tax and then for corporations to pay those dividends as franked dividends so that the individual shareholder receives a credit for the underlying corporate tax.

This contrasts with the USA system being the classical system where the dividends are taxed again. In the USA this leads to companies paying lower dividends, to cash being hoarded by corporations and used to overpay executives and for high priced take-overs as a way to give cash to the offer or shareholders as a capital gain. In contrast in Australia, franked dividends are sought after by retirees and investors generally. This leads to higher pay out ratios and greater efficiency in the rationing of capital by corporations. Then if a corporation requires funds for a new project, they can justify the new project to shareholders and raise funds as a separate exercise.

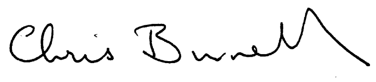
The efficiency of the Australian system appears to be underestimated by many, including those who simply look at corporate tax rates and say that the Australian tax rates could be lower. In our view this logic is erroneous. What is important is that the corporate tax rate is set at the common individual marginal tax rate of around 30%. It needs to be remembered in the USA that there are often State income taxes and property taxes so that a number of these comparisons of pure corporate tax rates internationally are invalid. This is in addition to double tax on dividends under the USA classical system.

Summary

I wish to thank you for the opportunity make this submission and trust the above will be given consideration.

Should you have any questions, please do not hesitate to contact me.

Yours truly,



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