Dear Minister Hon. Joe Hockey and and Members of the Financial System Inquiry Panel

Response on behalf of the members of ISEEE to your request for submissions on the issues set out in the Terms of Reference for the Government's Financial System Inquiry.

Introduction

The ISEEE is an educational body (incorporated in NY) which seeks to provide educational opportunities through sharing information on topics such as market structure and regulation, leveraging the expertise of former exchange executives, regulators and market professionals from around the world.

Collectively ISEEE members probably represent the deepest single pool available of experience and knowledge of global capital markets, structure, regulation and operations.

Our website contains materials contributed by members to our collective discussions, and you will find contributions from our Meetings there.

Each Year since 2009, ISEEE has published a "Declaration" following its meetings, in which we review progress against our recommendations for Global Capital Market reforms. The Budapest Declaration 2013 : "Revitalising Capital Markets for Jobs and Growth" is the last published.

Focus of Inquiry

The invitation to submissions notes that "Submissions should highlight particular issues, ideas, data or research that may be relevant to the Inquiry".

We would like to direct the attention of the Committee to three important areas of focus:

1. GOVERNANCE

In 2009 we commented that "at the heart of the endless cycle of boom and bust, greed and fear, in the 400 years of capital markets, are failures of good governance at all levels – of government policy affecting markets, risk and costs to the public; of the implementation of financial regulation; and of systemically significant financial businesses.

Extending regulation and oversight to all systemically significant financial entities will only extend prevailing inadequacies ***unless*** the governance concerns about the structuring, recruitment and retention, independence and integrity of oversight, administration and enforcement organizations are seriously addressed."

Since then, Governments have done some work on extending regulation and oversight to systemically financial entities. However, little has been done to address the governance concerns about the regulatory organisations that implement financial market regulation, however well intentioned that legislation is. We refer to some of these concerns under our "Action Points" below.

In an environment of growing complexity of technology, systems and regulations to address these, where few people have an overall understanding of how financial markets work, the 2012 publication "Guardians of FInance: Making Regulators work for us" is a useful reminder of the need to constantly assure the public of the effectiveness of our national markets, that the public interest is being served by the rules being enforced, and the people who enact and apply them. We commend their recommendations for your consideration during the course of this inquiry.

2. MARKET STRUCTURE

Market structure development in recent decades has been driven by concerns for efficient market pricing, greater transparency and accountability, better governance of large corporates, and separation of activities where the potential for conflicts of interest are present.

Regulation to achieve this has inevitably increased compliance costs and created barriers to entry to financial markets, enfranchised licensed operators, and encouraged intermediaries, service firms and asset managers to merge to gain size, lower unit costs and improve dominant position advantages.

Market structure is intrinsically tied up with market regulation and modern legislation needs to provide for multiple markets, governance approaches, and opportunities for small business that is not being met by the traditional market regulation approaches in most developed countries. At the same time it needs to be principled, simple and easy to understand and follow.

Market structures like NMS in the US have allowed major intermediaries to capture arbitrage opportunities from regulations intended to improve pricing efficiencies for ordinary investors. Pricing is now driven in some markets more by arbitrage than fundamentals. Dark pools and other markets have developed in response to the capture of traditional public markets by high-frequency traders and permitting co-location (prohibited in earlier times under equality of access rules).

Separation of the functions of research, promotion, market making and taking principal positions, advice, trading and aftermarket support, in order to remove conflicts, have eliminated the cross-subsidies that previously supported small market offers, and have meant that supporting small business small market offers is no longer profitable for intermediaries.

Furthermore, growth in funds under management, licensing requirements, and the lowering of disclosure costs for issuers who make private offers, or offers only to wholesale investors, have denied ordinary investors direct access to investment opportunities - now available only through intermediaries or asset managers at costly margins - and limited the pool of funds available to risky investments. Concentration of investment decisions in the hands of fewer larger asset managers and proliferation of derivative instruments has increased systemic risks and the potential for significant volatility.

Equity Market Structures needs principled reform not patching

ISEEE members have been pleased at the response to the progressive and extended decline in the US IPO market in the form of the US JOBS Bill (enacted in March 2012 in the US Congress), but have expressed concern about the inadequate performance and speed of regulators in dealing with complexity and change.

While members saw the work of lawmakers as a credible first step towards the restoration of the US IPO market, a focus on reducing costs for issuers was only part of the structural problem arising from the combination of regulatory developments and market responses, and more is now needed to provide suitable structures for markets to support small business IPOs.

Developments in the US are relevant worldwide with similar trends in most developed markets, and difficulties for small markets in Europe, but many emerging markets are still seeing substantial organic growth and are yet to see the impact of traditional overregulation on low or no growth economies.

A relevant OECD Working Paper authored in part by ISEEE member David Weild, is "Making Stock Markets Work to Support Economic Growth: Implications for Governments, Regulators, Stock Exchanges, Corporate Issuers and their Investors". We recommend it for reading by the Panel as background to the issues facing Australia.

Concerns consistently raised by members and relevant also to Australia are:

Capital Formation: The detrimental impact of current market structures on capital formation.

1. **Recommendation**: Government authorities should focus on revitalizing the initial public offering (IPO) markets by working with the private sector to improve the market structure to provide more support and liquidity for small and micro capitalization companies.
2. **Recommendation**: Government authorities should undertake a full analysis of the direct and indirect costs of going public and maintaining a public company to assure everyone that the associated obligations are appropriate and reasonable for the size of the company.

Market Regulation: Oversight and Transparency need to be improved.

1. **Recommendation:** Countries must have a national (centralized) trading surveillance, data collection and enforcement system.
2. **Recommendation:** Markets and industry participants should move to a shorter (minimum) settlement period to reduce opportunities for manipulation, minimize systemic risk and increase investor confidence.

Market Quality: Large and small capitalization stocks and investors are worlds apart.

1. **Recommendation:** Regulators should work jointly with the authorities of other markets to address the erosion of support for small and micro capitalization stocks and their investors.
2. R**ecommendation:** Regulators should develop appropriate metrics of market quality for different market capitalization segments.

3. SMALL BUSINESS CAPITAL FORMATION

In 2013 our Small Business Financing Crisis Task Force issued a report on "Opening the World's Equity Markets to Small, Medium Sized Companies", which is our first report on addressing the decline in small business IPOs.

The report notes that developed market structures and regulation are oriented towards efficient large public markets and that a one-size-fits-all approach is not appropriate; that small growth businesses are essential for the health of the economy, growth and jobs, and that small and new more risky businesses have trouble accessing capital finance.

The report proposes a regulatory carve out for Small Business Markets in traditional regulated market environments.

We now see some elements of this being recognized in the JOBS Act in the US and trials of market structure changes. We are also now seeing steps towards recognition of size and diversity differences in regulatory frameworks - such as in New Zealand under its new Financial Markets Conduct legislation.

Further reports are being worked on for alternative financing approaches (such as crowdfunding, Small and Direct Public Offers and Peer to Peer lending) and we have created a new Task Force on Emerging Market development.

12 Action Points for Reform

We recommend that the Committee conduct its review bearing in mind our 12 Action Points for Global Market reform, and use this once in a generation opportunity to show the leadership of Australia on each of the Action Points:

Balanced and Comprehensive Reform Needed, as set out in the prior Orlando Declarations

The Twelve actions are outlined, together with members comments on action or inaction over the last year *in italics*:
Action One: Improved Governance: the governance concerns about the structuring, recruitment and retention, independence and integrity of oversight, administration and enforcement organizations must be seriously addressed. *These concerns remain to be addressed, particularly concerns regarding independence, accountability and responsibility.*
Action Two: Independence: Regulatory authorities should be independent, as the judiciary and auditors are expected to be. *Members saw no changes to improve independence and confidence in regulatory judgement and observed less independence. Members supported separate and independent regulation of capital markets, and were*

against moves to concentrate financial market regulation (including securities markets) under a Central Bank, as it reduces the concern for capital markets.

Action Three: Remuneration and Incentives: Remuneration incentives should not positively encourage institutional risk taking with assets held for safekeeping. *Some initiatives to cap remuneration related to institutional risk taking were observed, but so were attempts to arbitrage such restrictions across jurisdictions. More efforts should be made to adopt a uniform international approach while avoiding structures and benchmarking that ratchet remuneration to excessive levels.*

Action Four: Regulators and Government Policy makers need to be encouraged to:

- Improve incentives to ensure high calibre staff and effective and independent supervision and enforcement; *No overall improvement was observed. Requirements for staff needed to be addressed as well as incentives.*
- Make rules and respond flexibly and quickly to rapidly changing market practices. *New rules have increased complexity, not reduced it, and regulators still follow market practices rather than anticipate them.*
- Keep their remuneration completely independent of any regulated entity or product; *There is recognition of the concern, but constant attention is needed.*
- Eliminate regulatory conflicts; *The issue is recognised but members did not observe governance initiatives to address partisan and revolving door appointments.*
- Avoid new restrictions on development; *Over-regulation is a major concern. e.g. regulation is not keeping up with innovations in financing small business (e.g. crowd-funding) and will suppress it when problems arise. This is now a point for positive action (new Action Point 12). Governments should also actively avoid redundancy in debating any proposed new legislation.*
- Extend regulation and supervision to all ***systemically significant entities;*** *Some positive moves to including non-banking financial and funds management in regulation are evident, and central clearing of derivatives is improving transparency, but initiatives like the FSB Legal Entity Identifier (LEI) are still at the beginning in collecting data to assist analysis. Some integrated data ideas are complicated (e.g. US) and supervision still lacks integrated data for oversight and market analysis.*
- Not blame Accounting Standards; *Positively, this seems to have been avoided.* and
- Review capital adequacy rules and seek ***smarter and better, not more, regulation***. *Stress and crisis testing initiatives were noted, but there are no outcomes yet. Requiring more capital, and more complex rules, are still inadequate responses.*

These are still significant challenges. Members noted the better IT tools now available to regulators, but that regulators remained behind the game rather than ahead of it.

Action Five: Transparency: All systemically significant entities should provide full public transparency of their operations. *Actions being taken such as shadow banking and dark pool disclosures. OTC central clearing, and improved identification of counter-parties (the LEI) were noted as positive.*

Action Six: Language: Everyone involved with the financial sector should encourage the media to avoid emotive language to describe products. *No obvious change in media reporting was observed.*

Action Seven: Complexity and Understanding: Ensure ***continuous education and training*** in capital markets, especially for officials and regulators and directors of systemically significant firms. *The OECD Plan for financial literacy was noted. members endorsed the continuing need for educational programmes and noted that ISEEE members were willing to assist with initiatives to improve understanding of markets and products.*

Action Eight: Ratings: Change the model to remove rating agency conflicts. *Some changes to incentives were positive, but no structural changes have been observed. members observed that removal of cross-referencing has diminished the significance of ratings. Members expressed the view that they did not want ratings to displace the need for issuer disclosure or investor responsibility.*
Action Nine: Oversight: Governments should establish agencies to review and oversee financial risk, and require explicit funding for those risks. *While some progress has been made, the extent of shadow banking operations are perceived as a continuing problem.*
Action Ten: Deposit Protection: Governments should either restrict the size of deposit taking institutions and allow them to fail, or guarantee deposits and regulate the management of depositors assets. Transparency and certainty of Government policy is missing. *Governments have not addressed the too-big-to-fail problem and, except in isolated examples (e.g. Switzerland) where banks have become smaller, have encouraged the formation of even bigger firms and concentrating risk by requiring more capital reserves.*
Action Eleven: Open Government: Governments should make all social policies explicit, fund them directly, and refrain from using indirect incentives or requirements to pursue them. *The use of Government sponsored or owned agencies to indirectly promote or support Government policy without explicit acknowledgement continues to be an issue.*
Action Twelve: Innovation: Governments should support and provide the appropriate legal framework for innovative financing mechanisms (e.g. crowd funding) and associated secondary markets, for micro, small and medium-sized entities. *Members were pleased to note that some countries are making regulatory changes to accommodate these developments.*

The Inquiry

We wish the Committee well in its review of the Australian Financial System and would be pleased to provide advice or comments on any matter within the scope of the Terms of Reference if that is of assistance to the Committee.

26 March 2014

William Foster
Vice Chairman
ISEEE

Terms of reference

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. how Australia funds its growth;
    2. domestic competition and international competitiveness; and
    3. the current cost, quality, safety and availability of financial services, products and capital for users.
2. The Inquiry will refresh the philosophy, principles and objectives underpinning the development of a well-functioning financial system, including:
    1. balancing competition, innovation, efficiency, stability and consumer protection;
    2. how financial risk is allocated and systemic risk is managed;
    3. assessing the effectiveness and need for financial regulation, including its impact on costs, flexibility, innovation, industry and among users;
    4. the role of Government; and
    5. the role, objectives, funding and performance of financial regulators including an international comparison.
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:
    1. the role and impact of new technologies, market innovations and changing consumer preferences and demography;
    2. international integration, including international financial regulation;
    3. changes in the way Australia sources and distributes capital, including the intermediation of savings through banks, non-bank financial institutions, insurance companies, superannuation funds and capital markets;
    4. changing organisational structures in the financial sector;
    5. corporate governance structures across the financial system and how they affect stakeholder interests; and
    6. developments in the payment system.
4. The Inquiry will recommend policy options that:
    1. promote a competitive and stable financial system that contributes to Australia's
    productivity growth;
    2. promote the efficient allocation of capital and cost efficient access and services for users;
    3. meet the needs of users with appropriate financial products and services;

    4. create an environment conducive to dynamic and innovative financial service providers; and
    5. relate to other matters that fall within this terms of reference.
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.
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.
7. 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.
8. The Inquiry may invite submissions and seek information from any persons or bodies.
9. 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.