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Financial System Inquiry
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Dear Panel Members

Financial System Inquiry Submission

We refer to the final terms of reference for the Financial System Inquiry (**FSI**) announced by the Commonwealth Treasurer, The Hon Joe Hockey, on 20 December 2013, and the request for initial submissions on the issues set out in the terms of reference by 31 March 2014.

We welcome the opportunity to make a submission as the issues set out in the terms of reference are of great importance to the future development and functioning of our financial system.

Our submission relates to a number of discrete legal and governance matters under six headings:

- improved access to financial products and markets;
- infrastructure development and funding;
- identification and resolution of legal uncertainty;
- improving the pace of financial reform;
- independence in the governance of Australia's financial system; and
- instituting an exchange tradable fixed term deposit market.

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1 Improved access to financial products and markets

Australia should both (a) negotiate mutual recognition arrangements wherever appropriate and seek to do so with greater urgency than in the past, particularly with countries in the Asia-Pacific region, and (b) broaden the use of unilateral recognition in a generic way, to facilitate access by Australian wholesale investors (consistently defined) to foreign financial products and markets.

Both mutual and unilateral recognition raise questions as to the appropriate philosophy on which we should allow foreign financial service providers to offer products to Australian investors or otherwise access our markets. In a world continuing to globalise, is it appropriate for there to be a "concrete" legal barrier which requires foreign financial service providers to comply with all aspects of Australian law and regulation when dealing with investors in Australia, or do we recognise that in certain circumstances foreign laws provide an appropriate basis for regulating the relationship between a foreign financial service provider and an investor in Australia. If so, should recognition be based on mutuality, equivalence, disclosure or some other basis (or a combination of factors)?

This submission focuses primarily on the ability of foreign financial service providers to deal with wholesale investors,[1] although similar issues arise in relation to dealing with retail investors.

Mutual recognition

The concept of mutual recognition is well known in domestic and international law.[2] Research indicates that significant benefits flow from mutual recognition.[3] However, it is our submission that historically mutual recognition has been of limited practical value in providing greater access by Australian investors to foreign financial products and markets (or by foreign investors to Australian financial products and markets). Achieving mutual recognition can be time consuming, particularly when it involves inter-governmental negotiations, international treaties and the enactment of domestic legislation.[4]

In our view, Australia should seek to negotiate mutual recognition arrangements wherever possible particularly with countries in the Asia-Pacific region. It may be that the Commonwealth should devote more resources to this task more urgently if Australia's financial services industry is to reap the benefits of mutual recognition.

Unilateral recognition

A more interesting question is whether, and under what circumstances, Australia should grant unilateral recognition to foreign laws and regulations to facilitate access to financial products and markets.

Whilst the Australian framework for the regulation of the financial system is highly developed and robust, it has been developed having regard to the objectives and needs of our society and is not necessarily the same as the framework which has developed in other countries. No matter how well the Australian framework and our regulators are regarded internationally, the simple fact is that Australia represents a relatively small part of the global economy and whilst we may "punch above our weight" at times, there are times when our laws and regulations (and our regulators) need to

1 This submission does not propose any changes to the current definitions in the Corporations Act 2001 of Australia (**Corporations Act**) and other legislation, which are relevant to determining whether a person is a wholesale investor in a given circumstance (e.g. "professional investor" and "wholesale client"). However, there are some inconsistencies in these definitions which should be examined. At a high level, the use of a consistent definition in all laws and regulations regulating Australia's financial services industry would be beneficial.

2 Mutual recognition refers to laws and regulations which promote the freedom of movement of goods and service providers in a national market (e.g. as set out in section 3 of the Mutual Recognition Act 1992 of Australia), or across national or other jurisdictional boundaries in a global market (as can be seen in the European Union).

3 For example, research conducted by the Australian Securities and Investment Commission (**ASIC**) in consultation with the New Zealand Securities Commission in relation to the Trans-Tasman mutual recognition of securities offerings regime demonstrated that mutual recognition arrangements can reduce industry costs, whilst maintaining high levels of investor protection (ASIC Media Release 09-205AD).

4 Where mutual recognition has been implemented (e.g. between Australia and New Zealand in a number of areas), the utility of that recognition is hampered by inflexibility in national legislation, and some reluctance by regulators to fully embrace the principle of mutuality.

accept that mutual recognition is a "bridge too far". We should accept that the framework in a foreign jurisdiction can be acceptable and appropriate in some circumstances, particularly when retail investors are not involved and consumer protection issues are less relevant.

Australian regulators already grant unilateral recognition to foreign laws and regulations to facilitate access to financial products and markets, albeit in a limited range of circumstances. For example:

(a) the recognition provided by ASIC in a limited number of class order exemptions from the financial services licensing regime in Chapter 7 of the Corporations Act for certain foreign financial service providers which operate in jurisdictions which have been assessed to have a similar level of investor protection to Australia.[5] The principles underlying such class order exemptions require that the regulation of the foreign financial service providers by their overseas regulatory authorities be sufficiently equivalent to regulation by ASIC, and that there are effective co-operation arrangements between the relevant overseas regulatory authorities and ASIC.[6] Whilst this has been a positive step, it can involve time consuming and difficult assessments and as a result only a limited number of such class order exemptions have been granted; and

(b) the exemption from the requirements of the Banking Act 1959 of Australia (**Banking Act**) for foreign corporations, authorised as banks in their home countries, to raise funds in the Australian wholesale capital market by way of issuing debt securities.[7] The exemption is simple to apply and has facilitated the development of the domestic "kangaroo" bond market by allowing access by a large number of foreign banks. The principles underlying this exemption are simple: authorisation as a bank in a foreign jurisdiction, and disclosure.

Both these examples limit the provision of financial services, or the issue of debt securities, to wholesale investors (albeit differently defined). However, they are based on different approaches: the first example requires authorisation in a foreign jurisdiction and equivalent regulation, whereas the second example requires authorisation in a foreign jurisdiction and disclosure (based on the assumption that such regulation is different).

In our opinion, there is a case for broadening the use of unilateral recognition in a generic way which "steers a middle course" between these two approaches to facilitate access by Australian wholesale investors (which, again, should be consistently defined) to foreign financial products and markets. Foreign corporations could be permitted to issue or distribute financial products, or provide another financial service, in Australia in the following circumstances:

5 Class order relief has been granted to certain foreign financial service providers regulated by the US Securities and Exchange Commission, US Federal Reserve, US Office of Comptroller of Currency, UK Financial Services Authority, Hong Kong Securities and Futures Commission, Monetary Authority of Singapore, US Commodity Futures Trading Commission and the German Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin) – ASIC Class Orders [03/1099], [03/1100], [03/1101], [03/1102], [03/1103], [04/100], [04/213], [04/829] and [04/1313]. It is unlikely that these five countries (the US, UK, Hong Kong, Singapore and Germany) are the only jurisdictions which have a similar level of investor protection to Australia.

6 Paragraph RG 176.8, ASIC Regulatory Guide 176 *Licensing: Discretionary powers—wholesale foreign financial services providers*.

7 Banking (Exemption) Order No. 82 which exempts such foreign corporations from compliance with section 66 of the Banking Act to the extent that the section prohibits the corporation from using the word 'bank' or 'banker' or 'banking' in relation to the business of raising funds in the Australian wholesale capital market by way of issuing debt securities. The exemption is only subject to two conditions: first, the debt securities being offered and/or traded in parcels of not less than A$500,000, and it being clearly stated on the securities and any related information memoranda that the debt securities are being issued by a bank that is not authorised under the Banking Act.

(i) the foreign corporation must be authorised in its home jurisdiction to issue or distribute the relevant financial product, or provide the relevant financial service;

(ii) the laws and regulations in the foreign corporation's home jurisdiction must comply with internationally accepted principles;[8]

(iii) the foreign corporation must issue or distribute the relevant financial product, or provide the relevant financial service in a manner which would comply, so far as is possible, with the applicable regulatory requirements as if it were doing so in its home jurisdiction in like circumstances;

(iv) the foreign corporation would be exempt from equivalent Australian regulatory requirements;[9]

(v) the foreign corporation must disclose that it is not subject to supervision or regulation by any of ASIC, the Australian Prudential Regulation Authority (**APRA**) nor any other Australian regulator, and that in issuing or distributing the relevant financial product, or providing the relevant financial service, it is doing so in accordance with the laws and regulations of its home jurisdiction which may be different from the applicable laws of Australia; and

(vi) the foreign corporation must provide reasonable details about the laws and regulations of its home jurisdiction (including how disputes are to be resolved).

In addition, in those jurisdictions where the regulatory regime has been previously examined and found to be robust (including those for which licensing relief has already been granted by ASIC),[10] further recognition of disclosure standards, procedures and documents should be permitted. A further priority should be to recognise and accept the liability principles prevailing in the home jurisdiction when a foreign corporation issues or distributes financial products, or provides another financial service, in Australia as our domestic principles are increasingly a barrier to entry (or alternatively, to bring our domestic principles into greater alignment with the liability principles which prevail in major foreign jurisdictions).

2 Infrastructure development and funding

The Commonwealth should develop a framework for the provision of a guarantee of the yield during the construction phase of major infrastructure projects so as to attract investment by superannuation funds.

This submission is being made at the same time as the Productivity Commission is conducting its inquiry into ways to encourage private financing and funding for major infrastructure projects, including issues relating to the high cost and the long lead times associated with these projects.

8 For example, if the foreign corporation is a bank, the foreign jurisdiction must adhere to the principles developed the Basel Committee on Banking Supervision, or if the foreign corporation is the distributor of a financial product, the principles published by the International Organization of Securities Commission. This requirement should be expressed in objective terms and be capable of being simply ascertained – it should not require an assessment of equivalence etc.

9 We envisage that the applicable Australian regulatory requirements would be set out in the relevant legislative instrument granting unilateral recognition.

10 See footnote 5.

Perhaps provocatively, the Federal Treasurer in his request to the Productivity Commission stated:

> "While alternative financing and funding models offer opportunities to reduce the immediate call on governments, it should be noted that the application of new models is not a panacea. Ultimately infrastructure can only be funded through taxation, borrowings or direct user charges. There are difficult trade-offs to consider given increasing demand and competing priorities."

This part of our submission is consistent with our views on the Productivity Commission inquiry and is confined to providing some observations regarding opening up the availability of construction funding of major infrastructure projects to a wider market that includes superannuation funds, both domestically and from off-shore.

We make some observations on three factors relevant to encouraging greater investment during the construction phase of major infrastructure projects (of course, there are other factors like income tax and other policy areas to be addressed):

- the availability of a revenue stream during construction to fund a yield to investors;
- creating liquidity; and
- the mitigation of demand risk during operations that could stop investment during construction.

Each of these could be facilitated by the Commonwealth.[11] Some reasons for the Commonwealth doing so might include:

(a) on many projects the Commonwealth already provides significant funding by grant or other contribution and so presently the Commonwealth has the funding liability and effectively accepts that its funds are subject to construction risk on many projects that it supports;

(b) the Commonwealth does not always obtain a revenue or other share of the benefits of its infrastructure grants other than through its long term taxation receipts from the project, but even that return is at risk if a project fails for lack of demand or revenue or even during construction;

(c) on any failed project, the potential revenue from taxation reduces or is deferred and so the Commonwealth, again, implicitly takes construction risk and demand risk for projects that do not pass the financial viability hurdle;

(d) if the Commonwealth does not take such steps, superannuation funds will seek offshore infrastructure investment rather than focus on greenfield and other development opportunities in Australia. Many large superannuation funds are already actively looking abroad.

A possible solution revolves around the Commonwealth taking a leadership position by offering a limited guarantee to investors during construction. A number of models could be considered. One is for the Commonwealth to provide a guarantee of the yield during construction (and beyond) for a specific project. Another is for the Commonwealth to establish a fund that sources capital from the superannuation funds and other investors, pools those funds and then invests the capital into projects through an aggregation or pooled fund. In return the superannuation investors receive a

[11] Whilst this submission outlines how the Commonwealth might approach this, the role could equally be taken by the States and Territories.

defined yield or volumetric yield and the Commonwealth manages the individual investments on a project by project basis. Such a pool would help solve the liquidity issues and enable trading in the instruments.

A guarantee mechanism has been used in the past for infrastructure projects. albeit the guarantee was provided by a private sector participant rather than the Commonwealth (but the Commonwealth or State ultimately met the costs of its provision through higher funding and return requirements of the private sector). The Commonwealth already uses its credit support power through the Export Finance and Insurance Corporation (**EFIC**) on offshore projects and even some Australian projects that have an export link. The framework is well understood and our suggestion is that a similar approach be taken to domestic projects to assist the deployment of superannuation funds domestically.

As and when a project reaches economic completion (i.e. a user pays model achieves a specified level of support or a PPP type of cash flow commences) and subject to the comments in the next paragraph, the Commonwealth guarantee would fall away and the superannuation fund investors would be exposed to the asset risk on a steady state basis.

The Commonwealth would presumably not wish to pay a yield and receive no return for say 3 or 4 years of guarantee support risk. Opportunity then exists to determine whether the Commonwealth could guarantee the yield during the operating phase as well, in return for a guarantee fee. So rather than switch off the guarantee support at a point of economic completion, the Commonwealth could enjoy the upside and the superannuation fund investors can receive a low risk and long term yield over a longer term.

It is open for the Commonwealth to work with the States and establish whether a revenue stream can be generated during construction on a user pays basis to mitigate this funding risk of the yield for the Commonwealth. One of the key issues confronting many infrastructure projects is that the revenue base is unknown until the asset is built and then operates until it reaches a “steady state” of revenue earnings. The well-publicised toll road failures now mean that “demand” risk or “patronage” risk is not a risk that the private sector will readily take.

However, in the regulated asset sector (eg power distribution networks, water utilities and the like) it should be possible to charge a group of users in advance for any capital expenditure programs. This is how many government businesses operate every day when managing their capital expenditure.

Further investigation of this technique should be explored to see if it can be applied case by case to other infrastructure projects where there is a suitable customer base. Usually this will require the State to apply a regulated pricing model to an asset during development and it is expected that the State and the Commonwealth will have a mutual interest in developing projects that might readily avail themselves to a user pays tariff during a construction or development phase. If this can be achieved, the yield can then be serviced from the customer base rather than have the Commonwealth service the yield. We are not ignoring the serious policy issues that could apply to any such introduction given the impost on a user group in the community but rather we think that including the possibility in the debate on how to unlock infrastructure investment is worthwhile.

Our suggestions above could assist in shaping the debate around how the financial system could be an enabler for facilitating infrastructure investment by superannuation and other investors.

3 Identification and resolution of legal uncertainty

A Financial Law Advisory Committee be established in Australia, overseen and co-ordinated by the Council of Financial Regulators, with terms of reference based on those attached in Part A of the schedule to this letter.

An element of legal uncertainty is inevitable in domestic and international financial markets that are efficient, competitive, innovative and flexible.[12]

Although the Australian framework for the regulation of the financial system is highly developed and robust, the pace of globalization and technological innovations in the financial industry over the past 16 years has accelerated the development of new ideas, financial products and market practices. This acceleration has at times raised uncertainties as to how the law will apply (sometimes based on misunderstandings about existing laws and regulations).[13] The pace of change in the future can also be reasonably expected to raise further uncertainties, and misunderstandings, as to how the law will apply.

New ideas, financial products or market practices may also highlight deficiencies in the existing legal and regulatory framework.[14] Where legislation has been introduced to recognise changes in financial markets, it often lags market practices[15] and could have been improved with greater industry consultation. The lack of legal certainty can impede the proper functioning of the Australian financial system, and could result in inefficiency, anti-competitiveness, inflexibility, increased costs and a lack of public confidence.

In addition, proposals (whether within Australia or overseas) for changes in law and regulation can give rise to uncertainties or misunderstandings, especially when specific features of Australian law or financial markets practice have not been fully or accurately reflected by the legislature, a regulator or other public authority, or are in conflict with the law or financial markets practice in overseas jurisdictions.[16]

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[12] Our comments in this section on the identification and resolution of legal uncertainty draw on the experience of the UK Financial Markets Law Committee (and its predecessor, the Financial Law Panel), and similar bodies established in the European Union, the United States and Japan.

[13] For example, international proposals for the statutory "bail-in" of bank creditors in certain circumstances (e.g. non-viability), and/or the exercise of crisis management powers by APRA, may conflict with the constitutional requirements that any acquisition of property must be 'on just terms' (section 51(xxxi) of the Australian Constitution). This possible conflict is one of the reasons why Australia has a adopted a contractual regime for the conversion or write-off of certain debts owed by an authorised deposit-taking institution rather than a statutory regime (which has been implemented in some foreign jurisdictions)

[14] For example, the interaction of provisions of the Payments Systems and Netting Act 1998 of Australia following the later in time amendments to the Banking Act which introduced the Financial Claims Scheme.

[15] For example, the introduction of rights issue prospectus exemptions and regulations to support Trans-Tasman mutual recognition, both of which still need further fine tuning to be effective.

[16] The US Foreign Account Tax Compliance Act (**FATCA**) and its effective extra-territorial operation affecting the operations of Australian financial institutions is in conflict with privacy, confidentiality and other laws in Australia, resulting in the need for the negotiation of an intergovernmental agreement between Australia and the United States.

In October 1992, the final report of The Legal Risk Review Committee (UK) which was established by the Bank of England following judicial decisions in the "swaps litigation"[17] proposed that a permanent Financial Law Panel be established as a forum to tackle any problems of legal uncertainty as they affected the UK wholesale financial markets. The Bank of England fully endorsed this recommendation, regarding it as an important initiative to strengthen the infrastructure of the UK's financial markets and, in co-operation with the Corporation of London, took immediate steps to implement it.[18] In 2002 the Financial Law Panel was replaced by the Financial Markets Law Committee.[19]

The role of the UK Financial Markets Law Committee is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which might give rise to material risks, and to consider how such issues should be addressed. The Committee also acts as a bridge to the judiciary to help UK courts remain up-to-date with developments in financial markets practice.[20] The role of the UK Financial Markets Law Committee has similarities to the roles of:

- the European Financial Markets Lawyers Group hosted by the European Central Bank;
- the Financial Markets Lawyers Group sponsored by the Federal Reserve Bank of New York; and
- the Financial Law Board supported by the Bank of Japan,

each of which has been established to propose recommendations on specific legal issues affecting the development of new ideas, financial products or market practices, and the proper functioning of the financial system and financial markets in the relevant jurisdiction.[21]

In Australia, the Corporations and Markets Advisory Committee (**CAMAC**) was established in 1989 to provide a source of independent advice to the Commonwealth on issues that arise in corporations and financial markets law and practice. However, the constitution, membership and reports of CAMAC[22] reflect an emphasis on both the regulatory functions allocated to ASIC following the recommendations of the 1996 Financial System Inquiry (the "Wallis report") (i.e. market integrity, consumer protection and corporations), and changes to legislation.

17 *Hazell v Hammersmith and Fulham London Borough Council*, [1990] 2 QB 697 (Court of Appeal) and [1992] 2 AC 1 (House of Lords).

18 Bank of England 1993 Annual Report and Accounts, page 16.

19 The Bank of England has continued to sponsor the Committee and provides the facilities for it to meet, including its secretariat.

20 See www.fmlc.org.

21 See www.efmlg.org, www.ny.frb.org and www.flb.gr.jp.

22 See www.camac.gov.au. CAMAC was (under its previous name of the Companies and Securities Advisory Committee) established by section 145 of the Australian Securities and Investments Commission Act 1989 of Australia and is continued in existence by section 261 of the Australian Securities & Investments Commission Act 2001 of Australia (**ASIC Act**). CAMAC is subject to Part 9 of the ASIC Act, and its members are appointed on the basis of their knowledge of, or experience in, business, the administration of companies, financial markets, financial products and financial services, law, economics or accounting. CAMAC has a separate Legal Committee and an Audit Committee, as well sub-committees for each current terms of reference.

CAMAC functions, pursuant to section 148(1) of the ASIC Act, are, on its own initiative or when requested by the Minister, to advise the Minister, and to make such recommendations as the Committee thinks fit, about any matter connected with (a) a proposal to make corporations legislation or to amend that legislation, (b) the operation or administration of corporations legislation, (c) law reform in relation to corporations legislation, (d) companies or a segment of the financial products and financial services industry, or (e) a proposal for improving the efficiency of the financial markets.

Whilst recognising the valuable work done by CAMAC since 1989 in relation to aspects of Australian financial markets law and practice[23], there is a need for an new advisory body, a Financial Law Advisory Committee, which can consider:

(a) domestic and international legal issues which impact Australia's financial system in a broader and more expansive manner than has occurred to date under the auspices of CAMAC;

(b) issues related to the regulatory functions allocated to APRA (i.e. prudential regulation of deposit-taking institutions, life and general insurance and superannuation) and the Reserve Bank of Australia (**RBA**) (i.e. monetary policy, the payments system and the overall stability of the financial system), as well as those allocated to ASIC; and

(c) the extent to which legal uncertainties or misunderstandings can be addressed through both legislative change and other means available to our financial regulators.

A Financial Law Advisory Committee could be separate to CAMAC (and assume some of CAMAC's current responsibilities), or represent an evolution of CAMAC into a new advisory body with broader responsibilities.[24]

In Australia, the Council of Financial Regulators (CFR), as the coordinating body for Australia's main financial regulatory agencies, would be an appropriate body to oversee and co-ordinate the work of a Financial Law Advisory Committee as the role of the CFR is to contribute to the efficiency and effectiveness of financial regulation, promote stability of the Australian financial system and, if the need arises, coordinate responses to potential threats to financial stability.

The role of a Financial Law Advisory Committee would be similar to that of the international advisory bodies described above. Part A of the schedule to this letter proposes draft terms of reference for a Financial Law Advisory Committee for your consideration, and Part B of the schedule to this letter illustrates some current areas of legal uncertainty and other anomalies which could be considered by a Financial Law Advisory Committee.

4 Improving the pace of financial reform

Australian governments, their agencies and instrumentalities should commit to a timely, transparent and effective process for the assessment of proposals and recommendations for reforms or changes in the laws and regulations relevant to Australia's financial system which are made by, or set out in a report commissioned by, them.

23 For example, reports on the Law of Derivatives: An International Comparison (January 1995), the Regulation of On-exchange and OTC Derivatives Markets (June 1997), and Netting in Financial Markets Transactions (June 1997). See CAMAC's website for a complete list of the reports published from 1991 until 2013.

24 The basis on which a Financial Law Advisory Committee would be established is not considered in this submission. For example, it could be established by legislation as a separate body corporate (as is the case for CAMAC), or it could be appointed by the CFR. The Financial Law Advisory Committee could be supported by a full-time executive (as is the case for CAMAC), or supported by a secretariat provided by the CFR or one of the members of the CFR (e.g. the RBA in a similar manner to the support provided by the Bank of England to the UK Financial Markets Law Committee).

In recent years, numerous independent and government sponsored inquiries and reports have considered issues related to the proper functioning of Australia's financial system, and put forward proposals for debate and/or made recommendations to government. Some examples are:

(a) the Australian Financial Centre Forum's report on Australia as a Financial Centre (January 2010) (the "Johnson Report");

(b) the report of the Australia's Future Tax System Review (May 2010) (the "Henry tax review");

(c) the report of the Senate Economics Committee on competition within the Australian banking sector (May 2011);

(d) the Commonwealth Treasury consultation paper (September 2012) seeking stakeholder views on a range of options directed at strengthening Australia's framework for financial regulation (including APRA's crisis management powers); and

(e) CAMAC reports on a wide range of helpful and desirable changes, all of which are available on the CAMAC website.

Some proposals and recommendations have been implemented, albeit at times slowly. Other proposals and recommendations have been rejected by government, again albeit at times slowly. However, frequently time lapses without any clear guidance from government as to whether or not proposals and recommendations will be progressed and implemented. This delay creates uncertainty and, in our opinion, limits the ability of participants in Australia's financial system to respond to new ideas, financial products or market practices and can result in inefficiency, anti-competitiveness, inflexibility, increased costs and a lack of public confidence.

In a speech to the *Funding Australia's Future* Forum[25] held in Sydney on 7 August 2013, Mark Johnson reflected on how change has been effected in Australia's financial system over his working career by considering two questions:[26]

- how is the good work that will come out of the *Funding Australia's Future* project going to influence policy?

- what are the institutional arrangements which influence policy, are they adequate and do they actually exist now?

In our opinion there is an urgent need for transparent and effective institutional arrangements to assess proposals and recommendations for reform so as to provide greater certainty for participants in financial markets. Where proposals or recommendations for reforms or changes in the laws and regulations relevant to Australia's financial system are made by, or set out in a report commissioned by, an Australian government or an agency or instrumentality of an Australian government, there should be clear guidelines for the assessment of those proposals or recommendations in a timely manner, and a transparent process of assessment.[27]

25 The Australian Centre for Financial Studies (**ACFS**) instigated the *Funding Australia's Future* project to examine current issues in the Australian financial sector and the need for reform. See www.australiancentre.com.au.

26 A copy of Mark Johnson's speaking notes is available from the ACFS website (see previous footnote).

27 In this context, we commend the approach generally adopted by APRA in recent years in releasing consultation packages for comment, outlining a clear timetable for submissions and responses (and providing information to market participants when delays occur), providing detailed responses to submissions and using the frequently asked questions (FAQ) format.

In particular, whenever such proposals or recommendations are made, the relevant Australian government, agency or instrumentality should commit to:

- a clear timetable for further submissions (if applicable);
- a clear timetable for responses by it (and provide information to market participants when delays occur); and
- providing detailed responses to submissions, especially when rejecting recommendations set out in a report commissioned by it,

and if legislative change is required, there should be a commitment by all Australian governments to promptly introduce draft legislation into Parliament and seek timely enactment of the legislation.

5 Independence in the governance of Australia's financial system

The governing body for all Australian financial regulators include a majority of non-executive (or independent) members.

The presence of some independent members on a governing body (and in some cases, a majority) has long been considered "best practice" for private and public companies, regulated institutions and other organisations. This feature is part of a broader concept of independence which is seen in a wide range of existing documents which relate to the appropriate regulatory philosophy and framework for financial systems. Independence is frequently linked to accountability, and the belief that independent directors assist organisations and executive management to be more accountable to stakeholders. Some examples are:

(a) Principle 2 of the *Objectives and Principles of Securities Regulation* published by the International Organization of Securities Commission (June 2010): "The Regulator should be operationally independent and accountable in the exercise of its functions and powers" and although this principle primarily relates to operational independence from government, it also recognises the need for regulators to be properly accountable;

(b) Principle 1 of the *Core Principles for Effective Banking Supervision* published by the Basel Committee on Banking Supervision (October 2006): "An effective system of banking supervision will have clear responsibilities and objectives for each authority involved in the supervision of banks. Each such authority should possess operational independence, transparent processes, <u>sound governance</u> and adequate resources, and be accountable for the discharge of its duties ..." (<u>our emphasis</u>);

(c) in discussing the roles, responsibilities, and composition of the board of directors, the report on *Principles for Financial Market Infrastructures* prepared by the Basel Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions (April 2012) states:

> "The board should be composed of suitable members with an appropriate mix of skills (including strategic and relevant technical skills), experience, and knowledge of the entity (including an understanding of the FMI's interconnectedness with other parts of the financial system). Members should also have a clear understanding of their roles in corporate governance, be able to devote sufficient time to their roles, ensure that their skills remain up-to-date, and have appropriate incentives to fulfil their roles. <u>Members should be able to</u>

exercise objective and independent judgment. Independence from the views of management typically requires the inclusion of non-executive board members, including independent board members, as appropriate. Definitions of an independent board member vary and often are determined by local laws and regulations, but the key characteristic of independence is the ability to exercise objective, independent judgment after fair consideration of all relevant information and views and without undue influence from executives or from inappropriate external parties or interests".[28] (our emphasis)

(d) the Board of the RBA comprises nine members: the Governor of the RBA (who is Chairman), the Deputy Governor of the RBA (who is Deputy Chairman) and the Secretary to the Commonwealth Treasury, and six non-executive (or independent) members who are appointed by the Commonwealth Treasurer.

Similarly, the Payment Systems Board of the RBA comprises up to eight members: the Governor of the RBA (who is Chairman), one representative of the RBA (a member of the Board of the RBA or the RBA service appointed by the Governor who is Deputy Chairman), one representative of APRA (a member of APRA or an APRA staff member appointed by APRA), and up to five non-executive (or independent) members who are appointed by the Commonwealth Treasurer;

(e) Common Prudential Standard 510 (**CPS 510**) published by APRA (January 21013) which sets out minimum foundations for good governance of a regulated institution in the deposit-taking, general insurance and life insurance industries. Among other matters, CPS 510 provides for:

- a majority of independent directors at all times;
- an independent chairperson;
- a majority of independent directors as members of the Audit Committee;
- auditor independence;
- a Remuneration Policy which does not compromise the independence of risk and financial control personnel in carrying out their functions; and
- an independent and adequately resourced internal audit function.

Independence allows a director or other member of a governing body to be objective and evaluate the performance of the organisation without any conflict of interest or the undue influence of interested parties. This includes independence from executive management. A greater number of independent directors / members can enhance the diversity of perspective which can be applied to the governance of the organisation.

In this context, much has been written about the cognitive capture of financial regulators by the regulated (i.e. where the regulator has "effectively internalized the objectives, concerns, world view and fears of the financial community" rather than looking at the objectives of society as a whole).[29] "The phenomenon of cognitive capture is exacerbated by the complexity of the financial system: complexity creates a type of opacity that incentivizes regulators to take shortcuts in their understanding of the many actors and products that comprise the system."[30]

[28] Paragraph 3.2.10.

[29] See Arnold Kling, *The Financial Crisis: Moral Failure or Cognitive Failure?*, 33 Harvard Journal of Law and Public Policy 507 (2010) ("Like the bankers themselves, the regulators believed that these innovations were making financial intermediation safer and more efficient."), quoted in Hilary J. Allen, *A New Philosophy For Financial Stability Regulation*, 45 Loyola University Chicago Law Journal (2013) 173.

[30] Allen, *supra*, at 199.

Our concern with the possible cognitive capture of financial regulators is the opposite of that commonly written about and described above. We do not believe that the experience of the last 16 years indicates that Australia's financial regulators have internalized the objectives, concerns and world view of regulated institutions. Rather, in our view there is a risk of the cognitive capture of financial regulators by their own objectives, concerns, world view and fears, without due regard to the objectives and needs of Australian society as a whole (and whether those objectives and needs are different to the objectives and needs of other countries).[31]

However, in our view the potential solution is the same, appointing independent directors / members to the governing bodies of our financial regulators as "regulatory contrarians" who will encourage the regulators to:

- take an outsider perspective on their work;
- consider the opposite outcome to which they are inclined to take;
- interact during the decision-making process with persons with differing backgrounds and biases; and
- publicly defend their positions, rather than merely assert a different point of view.[32]

The concept of independent members of the governing body of a regulator is already known in Australian law and should be applied to APRA, ASIC and other bodies in a similar manner in which it applies to the RBA. Such independent directors / members will also assist our financial regulators to more effectively consider the extent to which Australia should assert our own patterns of regulation, rather than relying on financial / prudential systems and global standards developed primarily in the US / European markets and designed to solve problems different from our own.

In the words of another commentator, "institutionalizing independent 'devil's advocates' within agencies to represent contrarian viewpoints; by forcing regulators to justify their positions using evidence and reason, they could reduce the influence of unconscious biases and reliance on illegitimate proxies".[33]

In summary, the principle of independence should apply equally to financial regulators as well as regulated institutions, and requires the governing body of a financial regulator to include a majority of non-executive (or independent) members.

6 Instituting an exchange tradable fixed term deposit market

The Commonwealth should take steps to facilitate the development of a market in exchange traded fixed term deposit products issued by Authorised Deposit-taking Institutions ("ADIs)"

An exchange traded fixed term deposit market would be a market in which wholesale and retail investors could trade via an exchange claims on ADIs which qualify as protected accounts under the

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31 For example (and adapting the words of paragraph 2 of the FSI's terms of reference), the need for a well-functioning financial system which balances competition, innovation, efficiency, stability and consumer protection, and which appropriately allocates financial risk and manages systemic risk.

32 See Brett McDonnell & Daniel Schwarcz, *Regulatory Contrarians*, 89 North Carolina Law Review 1629 (2011), also quoted in Allen, *supra*, at 200.

33 See James Kwak, *Cultural Capital and the Financial Crisis*, in *Preventing Regulatory Capture: Special interest influence in regulation, and how to limit it* (Daniel Carpenter & David Moss eds.), Cambridge University Press (2013), also quoted in Allen, supra, at 200.

Banking Act and accordingly benefit from the protection afforded by the provisions of Division 2AA of Part II of the Banking Act ("**Financial Claims Scheme**") (to the extent of the limit of that scheme) and the priority afforded by section 13A(3) of the Banking Act over claims owed to general creditors of the ADI.

The term of the deposit would be a fixed term greater than 30 days, or such longer tenor as is agreed. The deposit would not be repayable before its stated maturity. Deposit terms would be simple – repayment of principal at the stated maturity and interest on a fixed or floating basis Trading would be able to take place in low denominations (e.g. as low as $1.00). It should be permissible for intermediaries, such as custodians or brokers to hold the deposits on trust for clients, and for the Financial Claims Scheme limit to be applied on the basis of the beneficial ownership of the client.

The benefits of a market of this kind would be:

(a) fixed term deposit funding would reduce liquidity risk for ADIs and transfer it to a capital market and may accordingly reduce the ADI's need to rely on RBA's committed liquidity facility to satisfy liquidity requirements;

(b) investors would be encouraged to invest in the market as the deposit would have the same security as a conventional deposit. The admission to an exchange and the ability to trade in low denominations enables investors to seek liquidity from fellow investors in the market; and

(c) the high quality of the obligations and the large quantities of deposits with ADI's in Australia increase the prospect of a liquid market developing. This in turn may assist the development of other fixed interest debt markets (e.g. corporate debt obligations).

By way of comparison, a traded deposit market exists in the United States, through brokers, with insurance cover from the Federal Deposit Insurance Corporation applied on the basis of the client's beneficial holding[34].

A number of provisions of Australian regulation currently impede the creation of such a market. These include:

- the "account" based definition of what is covered by the Financial Claims Scheme and afforded the priority under section 13A(3) of the Banking Act[35];

- for deposits of a tenor over two years, the uncertainty of the definition of "basic deposit product" in the Corporations Act[36];

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34 See http://www.fdic.gov/deposit/deposits/certificate/

35 Sections 5(4),(5), (6) and (7) of the Banking Act. The Banking Act does not define "account" and its application to a tradable security is uncertain. The concept of a "protected account" for the purposes of the Financial Claims Scheme is also a different concept to a "deposit", although there is considerable overlap between the two concepts and uncertainties also arise from the interaction of the these and related concepts (i.e. "account-holder" "depositor").

36 Deposits with a tenor of over two years may not be "basic deposit products" under the definition of section 761A of the Corporations Act, which increases the compliance burden in offering them, however simple their terms. The regulatory issues are canvassed in ASIC Consultation Paper CP 169 (November 2011).

- for deposits placed with intermediaries, the pooled account provisions for the calculation of amounts covered by the Financial Claims Scheme[37] and the application of the managed investment scheme provisions in Part 5C of the Corporations Act.

Modest reform of these provisions would facilitate the development of an exchange tradable fixed term deposit market.

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We are making these submissions on behalf of our firm, and the views expressed are our own and not those of any of our clients.

We would welcome the opportunity to discuss these submissions with panel members of the FSI. Please contact:

- Berkeley Cox, the firm's Managing Partner, Banking & Finance on 07 3244 8149 / berkeley.cox@au.kwm.com; or

- Greg Hammond or Ian Paterson (partners) on 02 9296 2487 / greg.hammond@au.kwm.com and 03 9643 4237 / ian.paterson@au.kwm.com respectively,

if there are any queries arising from this submission.

Yours faithfully

King & Wood Mallesons

[37] Section 16AFof the Banking Act.

SCHEDULE

Part A – draft terms of reference for a Financial Law Advisory Committee

The Financial Law Advisory Committee is to:

(a) identify issues which may give rise to legal uncertainty, or misunderstanding, present and future, in the regulatory framework for Australia's financial system; and

(b) consider proposals (whether within Australia or overseas) for changes in law and regulation which may give rise to legal uncertainties, or misunderstandings,

which might give rise to material risks or cause practical difficulties in introducing new ideas, financial products or market practices, and to make recommendations to the Council of Financial Regulators and Australian governments as to how such matters should be addressed.

In particular, the Financial Law Advisory Committee is to:

(i) provide a forum for participants in Australia's financial system to discuss issues, and proposals for changes in law and regulation, which may give rise to legal uncertainties, or misunderstandings;

(ii) serve as a channel of communication between legal professionals and the Council of Financial Regulators and Australian governments in relation to such matters

(iii) enhance knowledge and understanding of legal issues which impact the integrity, efficiency, competitiveness, innovative capacity and flexibility of Australia's financial system;

(iv) foster understanding of and, when possible, make recommendations to diminish legal risks in the regulatory framework for Australia's financial system;

(v) when requested by the Council of Financial Regulators or an Australian government, to assist in the drafting of laws and regulations that will enhance the integrity, efficiency, competitiveness, innovative capacity and flexibility of Australia's financial system;

(vi) develop recommendations and prepare issue papers and model contracts on specific market-related topics for circulation to participants in Australia's financial system; and

(vii) provide support for legal positions in litigation (including by means of amicus briefs) which is expected to affect significantly the proper functioning of Australia's financial system.

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Part B - some current areas of legal uncertainty and other anomalies to be considered by a Financial Law Advisory Committee[38]

(a) The circumstances in which superannuation funds may be treated as "professional investors" for the purposes of Chapter 6 of the Corporations Act and as "wholesale clients" under Chapter 7 of the Corporations Act.

(b) The provisions of the Corporations Act and other legislation which apply, or do not apply, to the administration of insolvent managed investment schemes (or other trusts).

(c) The ability of third parties to rely on a decision of the directors of a company that the giving of financial assistance to a person to acquire shares (or units of shares) in the company or a holding company of the company does not materially prejudice the interests of the company or its shareholders, or the company's ability to pay its creditors (see section 260A(1)(a of the Corporations Act).

(d) The application of the insider trading provisions of the Corporations Act to the trading of loans between banks and other wholesale participants in the secondary debt market, and the extent to which (i) the making of loans by a bank constitutes the creation of a debenture by the borrower for the purposes of the Corporations Act, and (ii) the extent to which a loan (retains its character as a debenture or not) after it has been traded in the secondary market .

(e) The interaction of provisions of the Banking Act which refer to "deposit", "depositor" or "deposit liabilities" (e.g. the use of the term "Authorised Deposit-taking Institution", the definition of "banking business" and references to the protection of depositors) and the provisions which refer to "protected accounts" and "account-holder" (e.g. section 13A(3) and Division 2AA of Part II of the Banking Act governing the Financial Claims Scheme).

(f) The nature of the "guarantee" provided by the Commonwealth under the Financial Claims Scheme and the need to re-evaluate the merits of ex-ante funding for the Scheme having regard to comments in the Australia: Financial System Stability Assessment report (November 2012) of the International Monetary Fund (IMF Country Report No. 12/308).

(g) The application of the Financial Sector (Collection of Data) Act 2001 of Australia to foreign corporations which do not carry on business in Australia, and the application of the term "domestic books" to determine the reporting obligations of such foreign corporations.

(h) Whether the breadth of the list of terms identified as potentially unfair leads to uncertainty in the financial markets (e.g. the securitisation of consumer loans) which outweigh the benefit derived from the classification of such terms as potentially unfair. A number of the listed terms potentially indicate risks associated with core features of consumer loans (e.g. unilateral variation rights are critical in the context of a loan written over a 25 to 30 year term), and in particular structures for funding them (e.g. the need for "clean" assignments in order to securitise or otherwise fund pools of loans).

(i) The application of tax and other laws to Islamic finance.

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38 These matters are not intended to be an exhaustive or comprehensive listing of all areas of legal uncertainty or anomalies which we have identified, but rather are indicative of the matters which could be considered by a Financial Law Advisory Committee. The presentation of these areas does not indicate an order of priority in which we think the issues should be addressed.

(j) Whether prudential standards and other legislative instruments, a breach of which can give rise to criminal sanctions, are susceptible to challenge on the basis that they are uncertain or unclear and do not allow entities subject to them to organise their affairs in such a way that does not break the law.

(k) The interaction of the "sale nominee" requirements of the Corporations Act with Australia's anti-money laundering legislation.

(l) The overlapping (and at times inconsistent) regimes for prospectus liability, product disclosure statement (**PDS**) liability, liability for "innocent misstatements" and other general liability under corporations and securities laws (in particular, liability imposed on directors, experts and underwriters), and the availability of differing and inconsistent defences.

(m) The interaction of the liability regimes referred to in the preceding paragraph with foreign corporations and securities laws in the context of multi-jurisdictional offerings by Australian entities.

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