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No. 59 2001–02

Commonwealth Inscribed Securities Amendment
Bill 2001

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Commonwealth Inscribed Stock Amendment Bill 2001

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19 September 2001

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Commonwealth Inscribed Stock Amendment Bill 2001

Date Introduced: 23 August 2001

House: House of Representatives

Portfolio: Treasury

Commencement: By Proclamation or within 6 months of Royal Assent

Purpose

To provide for:

- the electronic creation, issue, recording and transfer of Commonwealth Government Securities (CGS);
- the electronic transfer of Commonwealth Government Securities by clearing and settlement facilities under the *Corporations Act 2001*, as proposed to be amended by the Financial Services Reform Bill;
- the creation of equitable interests in CGS;
- the electronic transfer of legal or equitable interests in CGS in accordance with regulations made under the *Commonwealth Inscribed Stock Act 1911* (CIS Act), that may apply a provision of the Corporations Act;
- the appointment of non-government clearing and settlement facilities regulated under the Corporations Act as Registrars under the CIS Act in addition to, or instead of, the Reserve Bank of Australia (RBA).

Background

Recent reforms to corporate law have gone some way towards recognising that Commonwealth law has at times failed to take account of the extent and speed of technological innovation in modern commercial practices. It is frequently alleged that the law is out of touch with the needs of contemporary business operations. The Corporate Law Economic Reform Program Report No. 5 stated:

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The increasing internationalisation of markets and economies highlights the need to ensure that policies maximise the competitiveness and efficiency of the domestic economy. Australia's laws must provide the development of systems and market practices that will reduce legal uncertainty and transaction costs, and increase trading efficiency. This will, in turn, facilitate the competitiveness of Australia's markets in the global trading environment.¹

The introduction of this Bill takes place against a general background of much recent corporate law reform activity, as well as reform of legislation applicable to electronic commerce. This has included the *Corporate Law Economic Reform Program Act 1999*, *Electronic Transactions Act 1999*, *Corporations Act 2001*, and the *Financial Services Reform Act 2001*. The latter Act makes provision for a streamlined regulatory regime for financial markets and clearing and settlement facilities, through amendments to the *Corporations Act 2001*.

Rationale for the Bill

The issue and trade of Commonwealth government securities is regulated by the *Commonwealth Inscribed Stock Act 1911*.² In summary, the Act is outdated legislation - to the extent to which it fails to take account of modern realities, such as electronic trading of securities. The Act does not acknowledge the fact that Commonwealth securities are already traded electronically, and have been so since 1991, with the introduction of the RITS system (*see*: below). An indication of the antiquity of the Act is the fact that it provides: "The Treasurer may establish a Registry for the inscription of stock at London in the United Kingdom" (s.14(b)).

A primary objective of the Bill is to increase the flexibility of options for trading in Commonwealth government securities. As well as providing for the electronic creation, issue, recording and transfer of Commonwealth Government Securities (CGS), the Bill provides for the appointment of non-government clearing and settlement facilities regulated under the Corporations Act as Registrars under the CIS Act in addition to, or instead of, the Reserve Bank of Australia.

Background on Commonwealth government securities

Commonwealth government securities are debt instruments (Treasury Bonds, and Treasury Notes) issued by the Commonwealth government. These devices are issued by the Commonwealth through the Registries of the Reserve Bank.

The raising, management and retiring of Commonwealth debt is overseen by the Australian Office of Financial Management (AOFM) which was established in July 1999 by the *Financial Management and Accountability Act 1997*. The AOFM is required to achieve these objectives at the lowest possible long-term cost, consistent with an acceptable degree of risk exposure.

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The trade in Commonwealth securities is an important aspect of monetary policy. According to the Reserve Bank:

Since the mid 1980s, the RBA has been implementing monetary policy through domestic market operations, rather than using direct controls on banks as was previously the case. The basic nature of these operations has not changed over the intervening period: in essence they involve either sales of securities to reduce the amount of funds in the money market (and so cause interest rates to rise) or purchases of securities to produce the opposite effect.³

At 30 June 2000, the total face value of net CGS on issue for the Commonwealth was \$74.4 billion or 11.8% of nominal GDP. At 30 June 1999, the level of debt was \$83.5 billion or 14.0% of nominal GDP. The value of daily bond market turnover in CGS is approximately \$3 billion.⁴

Treasury Notes are short term discount securities with maturities of 13 and 26 weeks issued by the Reserve Bank on behalf of the Commonwealth government. Treasury Notes are issued by competitive tender at regular intervals, usually weekly. Treasury Notes are used by the Commonwealth in order to borrow short term funds from the money market. This borrowing is necessary because the day-to-day timing of Commonwealth receipts does not match the pattern of its outlays. By targeting the maturity of short term borrowings to projected periods of cash surplus, the Commonwealth can achieve the management of its cash balances.

Treasury Bonds include Treasury fixed coupon bonds, Treasury adjustable rate bonds, and Treasury indexed bonds. Treasury Bonds are medium to long-term coupon securities issued by way of inscribed stock. (Inscribed stock is a term used to refer to securities, title to which is recorded in a register, rather than acknowledged by the issue of a certificate of ownership.) The Reserve Bank manages registries of inscribed stock at its branches.

Bonds are usually fixed interest securities upon which interest is paid at regular intervals. Treasury Bonds are of various maturities and are also issued to the market by competitive tender. Institutions who wish to make a tender bid must be registered with the Reserve Bank or use registered bidders as agents. Treasury Bonds are the major debt instrument currently issued by the Commonwealth. Treasury indexed Bonds only play a minor role in Commonwealth debt issuance. During the financial year 2001-2002, the Australian Office of Financial Management is planning issuance of between \$2 billion and \$3 billion of Treasury fixed coupon Bonds, and \$200 million of Treasury indexed bonds.⁵

The Reserve Bank Information and Transfer System (RITS)

RITS is an electronic system, established and operated since August 1991 by the Reserve Bank, which allows trade in Commonwealth Government Securities. RITS provides facilities for electronic tendering for CGS. Its primary function is the electronic settlement and transfer of transactions in CGS.

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By way of comparison, in other markets, CHESSE, the Clearing House Electronic Sub-Register System is the clearing and settlement system for equities involving the Australian stock exchange and the banking system. It enables electronic transfer of title to securities and electronic payment instead of payment by cheque.

By virtue of electronic processing, RITS allows Commonwealth Government Securities to be transferred and settled simultaneously (on a 'delivery versus payment' basis), in real-time. The RITS system also provides automatic interest and maturity payments for securities lodged in the system.

According to the RBA: 'Over 99 per cent of CGS turnover in the market is handled by RITS and securities with a face value of \$64 billion are lodged in the system. There are 136 members of the system representing 248 organisations.'⁶

Members of RITS include all the banks and other major traders of CGS. Non-bank members (other than credit unions and building societies) must have a member bank take responsibility for their payments. Credit unions and building societies may use their SSP member.⁷

The other function of RITS is for settling the inter-bank component of equity transactions on CHESSE, the Australian Stock Exchange's electronic settlement system. RITS is Australia's real-time gross settlement (RTGS) system and is the means through which banks and other approved institutions access their Exchange Settlement accounts with the RBA.⁸

Relationship between RITS and the Bill

The operation of the RITS system is not specifically provided for in legislation. The *Commonwealth Inscribed Stock Act* of 1911, as it stands, does not make provision for the electronic settlement of CGS transactions. The Act is desperately in need of modernisation, as it only provides for transactions and transfers of legal title in CGS to be settled by means of a paper based system. However electronic trade in CGS has proceeded since 1991, in spite of the precise text of the legislation.

The CIS Act has not presented any legal obstacles to the establishment and use of an electronic system for the transfer of beneficial interests in CGS. In practice, the Reserve Bank's RITS system has been performing this function since 1991. The practice has been to grant a legal interest known as a "chose in action" (a form of property right which is enforceable by court action) in relation to Commonwealth government securities, in order to overcome the existing impediments to electronic transfer of the securities presented by the deficiencies of the CIS Act. This involves electronic trading using the following transfer process. Legal and beneficial ownership of securities lodged in the RITS system by a trading member passes to the Reserve Bank (RBA). In return, the RBA grants the member a chose in action. This chose in action is then transferred through RITS. The chose in action entitles the member to direct the Reserve Bank to deliver to the member

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securities of a specified description and value. A member does not have a proprietary interest in any of the securities. Securities of the same description may be described as fungible.⁹

However, it is proposed that with amendment of the CIS Act, the electronic transfer of the direct beneficial and legal interests in Commonwealth securities could take place without resort to the device of a chose in action. This amendment of the *Commonwealth Inscribed Stock Act* was suggested in Report No 5 of the Corporate Law Economic Reform Programme, entitled "Electronic Commerce: Cutting Cybertape -Building Business". This CLERP report presented recommendations aimed at removing legal and regulatory impediments to developments in electronic commerce.

Opening up Government securities market to other settlement facilities

When introducing the Bill, by way of 2nd Reading Speech on 23 August 2001, the Hon. Tony Abbott, Minister for Employment, Workplace Relations and Small Business raised an important aspect of the Bill – which is to open up the Commonwealth government securities market to clearing and settlement facilities other than the Reserve Bank's RITS system. He said:

The Commonwealth Inscribed Stock Amendment Bill will provide a legal framework for the electronic transfer of Commonwealth government securities that is flexible and that promotes an efficient and innovative market. The bill will create a more efficient business environment for market participants by opening up the conduct of the Commonwealth government securities market to clearing and settlement facilities involved in the broader operation of the financial markets. The bill will make clear that non-government clearing and settlement facilities regulated under the Corporations Act may be appointed as registrars under the Commonwealth Inscribed Stock Act in addition to, or instead of, the Reserve Bank. However, the bill will not preclude the Reserve Bank from continuing to have a role as a registrar.

Main Provisions

Item 2 proposes the insertion of the term 'clearing and settlement facility' into section 3 of the CIS Act. That term is defined as a clearing and settlement facility for the purposes of Chapter 7 of the *Corporations Act 2001*.

Item 4 proposes a new definition of 'stock', to take account of changes proposed in this Bill.

Item 8 proposes additions to section 7 of the *CIS Act* to enable stock to be issued by electronic means, and issued to a person (including a registrar) on trust for other persons. These changes will remove doubt that the Commonwealth can create equitable interests in relation to CGS.

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Item 12 (new subsection 14 (2)) will enable any person to be appointed by the Treasurer as a Registrar under the Act. As proposed this will include other clearing and settlement facilities regulated under the *Corporations Act*.

Item 14 inserts new subsection 15 (2) which will provide that a stock ledger may be kept in electronic form.

Item 19 inserts new subsection 24 (1) which provides that regulations may be made to enable the transfer of legal or equitable interests in stock from one person to another.

Item 20 proposes the insertion of three new sections following section 24. **New section 24A** will provide that where a clearing facility is appointed as a registrar, legal and equitable interests inscribed in a ledger kept by that facility can be transferred according to the rules of the facility as governed by the *Corporations Act 2001*.

Concluding Comments

Although ‘infrastructure issues’ such as the existence of reliable and timely clearing, transfer and settlement systems are essential to the efficient functioning of markets in government securities, there are other more fundamental issues at stake. According to Mr Peter McRae, Deputy Chief Executive Officer, Australian Office of Financial Management:

The ultimate threshold issue in seeking to make participation in the bond market an attractive proposition for investors and intermediaries is that there be an economic case for doing so. No matter how robust is a market infrastructure or how efficient its operational features might be these considerations will not of themselves generate major development momentum if the product itself is unattractive in economic terms.¹⁰

Endnotes

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- 1 Commonwealth of Australia (1997), *Electronic Commerce: Cutting Cybertape -Building Business*, Report No 5 of the Corporate Law Economic Reform Programme, AGPS, Canberra, p. 5.
 - 2 Note that the Commonwealth has crown immunity from the obligations of the Corporations Law in respect of debt issues.
 - 3 Reserve Bank of Australia (2001) *Annual Report 2001*, p. 5.
 - 4 Peter McCray, Deputy Chief Executive Officer, Australian Office of Financial Management (2000) “The Australian Government Bond Market”, Paper presented to the Asian

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Development Bank Conference on Government Bond Markets and Financial Sector
Development in Developing Asian Economies, 28-30 March 2000, Manila, Philippines.

- 5 AOFM, Media release, 29 June 2001.
- 6 RBA, Annual Report 2001, p. 42.
- 7 <http://www.apca.com.au/Paymentinstruments.htm> (Australian Payments Clearing Association Limited)
- 8 RBA, Annual Report 2000, p.42.
- 9 Commonwealth of Australia (1997), *Electronic Commerce: Cutting Cybertape -Building Business*, Report No 5 of the Corporate Law Economic Reform Programme, AGPS, Canberra, p. 50.
- 10 Peter McCray, op.cit..

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