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6/2/06  
The Manager  
Taxation of Financial Arrangements  
Business Income Division  
Revenue Group  
Department of the Treasury  
Langton Crescent  
PARKES ACT 2600

Dear Sir/Madam,

**TAXATION OF FINANCIAL ARRANGEMENTS (TOFA) STAGES 3 & 4 – Exposure Draft Bill (“The Bill”)**

SFE Corporation (SFE) is the operator of Sydney Futures Exchange on which contracts are traded in derivatives (futures and option contracts) across five major markets – equities, interest rates, currency, commodities and energy. During 2005, on average over 250,000 contracts with a nominal principal value of \$96 billion were traded each day. SFE also operates Austraclear the central securities depository, which settles approximately \$20 billion in interest rate securities each day.

As noted in our earlier submission in relation to the coherent principles, SFE would support any reform which promotes efficiency in the markets in which SFE operates. SFE believes that efficient financial markets are essential in order to lower Australia’s cost of capital, facilitate efficient capital allocation throughout the economy and to promote Australia as a financial centre in the Asian time zone.

SFE broadly welcomes the initiatives embodied in the draft legislation, and in particular the elective tax-timing hedging method, which we note is significantly broader than was originally contemplated. However we believe that there are 2 significant issues that need to be addressed as part of the proposed new legislation:

**1. Capital v. Revenue (“character mismatch”)**

Under the new TOFA rules any transaction that is a "financial arrangement" will be taxed on revenue account. We submit that this may result in tax outcomes that may seriously frustrate the objective of the Bill to “tax gains and losses from financial arrangements in a way that minimises distortions to investment, financing decisions, risk taking and risk management” (2.17 of the Explanatory Material).

SFE Corporation Limited group companies are:

Sydney Futures Exchange Limited | SFE Clearing Corporation Pty Ltd | Austraclear Limited

We draw this conclusion because there is a potentially significant mismatch opened up by this legislation for any taxpayer who is hedging something on capital account with a "financial arrangement" which, because of the Bill, will now be taxed on revenue account.

## 2. Synthetic transactions

Financial markets participants may enter into financial arrangements ("synthetics") that generate equivalent financial outcomes (before tax) that are the same or very similar to other financial transactions. The purpose of the synthetic is often to avoid some form of friction in the ("natural") transaction being synthesised, for example high transaction costs or lack of liquidity. This is perhaps best illustrated by an example:

*A "natural" position in a portfolio of stocks can be replicated by purchasing a discount security such as a bank accepted bill, and going long (buying) a SPI200 futures contract on SFE (the two contracts together being a "synthetic" position). These two transactions would be significantly easier and cheaper to effect than actually buying each of the individual stocks separately. It can be easily proven mathematically that the two will result in similar gross returns<sup>1</sup>. However, on an after-tax basis, synthetic exposure differs from exposure obtained directly through stocks. Exposure obtained synthetically requires traders to keep rolling over their position in the futures contract (and potentially also a discount security) which results in the realisation of tax gains and losses. This in turn results in a distortion in the market. Currently investors prefer, purely for tax reasons, to obtain exposure directly through purchasing stocks despite the large transaction cost advantages afforded by stock index futures<sup>2</sup>.*

Notwithstanding the declared intention of the legislation to promote economic neutrality and symmetry between different financial arrangements having the same economic effect (i.e. to remove any tax distortions in the system) the Bill falls short because:

A. If the synthetic is a "financial arrangement" it will be on revenue account whereas the natural transaction may have been on capital account. This may create distortions/affect behaviour.

B. The application of the TOFA rules will most likely result in taxation liabilities crystallising in a different time pattern for the synthetic as compared to the natural. An example is the quarterly settlement of SPI futures whereas the holding of a portfolio of actual shares would be taxed on realisation.

The removal of the taxation distortions would promote competition between the natural and synthetic markets, potentially driving down transaction costs and therefore the overall cost of capital with flow-on benefits to the economy at large.

Provided appropriate revenue safeguards are in place, we see no reason why an election to adopt a tax treatment equivalent, in all respects, to the hedged position should not be available to taxpayers wishing to hedge an exposure (refer 1. above). Nor do we see a reason why an election to adopt a tax treatment equivalent to the natural outcome (refer 2. above) should not be available to taxpayers wishing to effect a synthetic solution.

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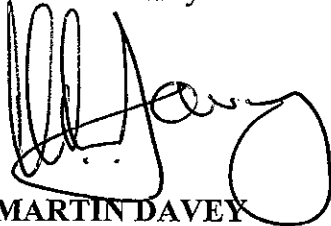
<sup>1</sup> Fabre, J., A. Frino and G. Wearin, (2004), "Do returns on synthetic portfolios constructed from stock index futures deliver capital gains, dividends and franking credits?", Journal of Law and Financial Management.

<sup>2</sup> Fleming, J, B. Ostdiek and B. Whaley (1996), "Trading costs and the relative rates of price discovery in stock, options and futures markets", Journal of Futures Markets.

SFE looks forward to working with Treasury to discuss these issues.

Should you wish to discuss any aspect of this submission please contact the writer or Mr. Ramy Aziz, Financial Controller on (02) 9256 0555, or our advisers, Chris Kinsella ((02) 8266 5996) or Gavin Marjoram ((02) 8266 0576) from PricewaterhouseCoopers, who have assisted with the drafting of this submission.

Yours faithfully

A handwritten signature in black ink, appearing to read 'M. Davey', with a large, stylized flourish at the end.

**MARTIN DAVEY**  
**Chief Financial Officer**