



8 February 2013

Manager, Financial Markets Unit
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Dear Mr McAuliffe

Options for Amending the ASIC Market Supervision Cost Recovery Arrangements

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Treasury review of the ASIC market supervision cost recovery arrangements.

These comments should be read in the context of AFMA's previous submissions to Treasury in relation to ASIC cost recovery. As noted in those submissions there are fundamental flaws in the Government's approach to cost recovery in relation to ASIC as it ignores existing excess ASIC related cost recovery measures and other contributions to revenue made by and through the financial services sector.

Further, as discussed in our previous submissions the scheme risks introducing significant inefficiencies into the market infrastructure and events have proved these concerns to be well founded.

Consistent with Treasury policy and the framework for reviews including *Australia's Future Tax System (the Henry Review)*, AFMA has consistently argued that government revenue should be raised through a few efficient and non-distortionary taxes. Poorly designed schemes risk structural harm to the economy even for modest revenue, require high levels of complexity in design, are costly to administer, lack transparency, and introduce undesirable conflicts of interest.

The ASIC market supervision cost recovery program has been an example of a program that suffers from these flaws. The program raises what are in budgetary terms relatively

small amounts but in doing so has risked structural harm by putting at risk the viability of market operator competition with a scheme of increasing complexity, that does not provide transparency with regard to how charges are calculated, that introduces moral hazard to ASIC spending in this area, and has elements of an undesirable tax design. The scheme design has made competition difficult and raised the barriers to entry for new market operators.

Policy makers should not assume that markets will continue to function efficiently under regulatory and cost burdens. Losing market efficiency and the breadth of market offerings due to regulatory intervention creates real risks for the economy.

AFMA again calls for the repeal of the cost recovery scheme and a move away from policies that drive an increasing number of inefficient and distortionary taxes, levies and charges and a renewed commitment to moving to an efficient tax base. AFMA opposes transaction taxes in general and notes Treasury assurances that the charge is not a tax.

In the alternate, if the scheme is not repealed, the industry majority view is to support the creation of a market maker exemption scheme as proposed in the paper and discussed at forums recently as a means of addressing, at least to some extent, the risks to market operator competition created by the cost recovery charges.

Our responses to the specific questions raised in the Paper are set out in the attached submission.

AFMA has welcomed the Treasury's and ASIC's extensive and ongoing dialogue in relation to the matters raised in the consultation. We would be pleased to discuss with you further any of the points made in this submission. I may be contacted at djeffree@afma.com.au or on (02) 9776 7993.

Yours sincerely

A handwritten signature in black ink that reads "Damian Jeffree". The signature is written in a cursive, slightly slanted style.

Damian Jeffree
Lead Director Markets



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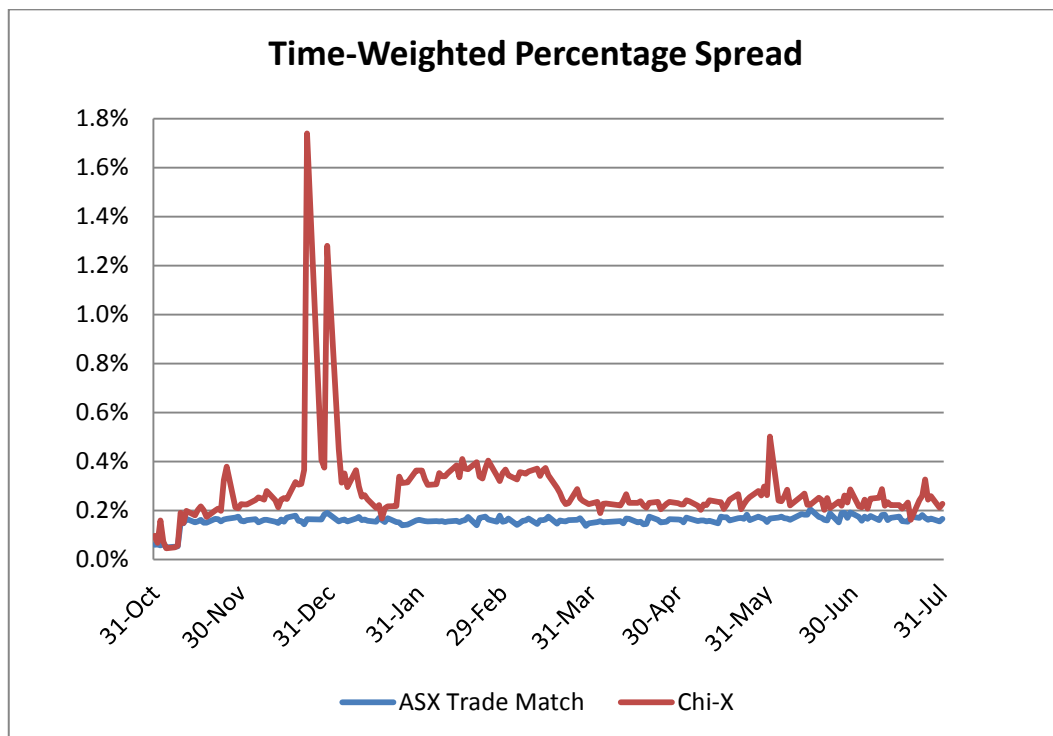
1. Do you consider that the impact of the current cost recovery approach on overall market quality has been (a) mostly neutral, (b) positive, (c) negative or (d) other? Please provide examples to support your answer.

AFMA views the impact of the cost recovery regime as (c) negative on overall market quality.

Indications of this decrease in market making quality in an environment of market operator competition can be seen in the graph below of the Chi-X market that includes the period of the introduction of the scheme in January 2012.

As would be expected, market making participants increased the width of their quoted spreads during this time (noting the two spikes are not indicative of the trend) to reduce the frequency with which prices would need to be adjusted and hence reduce exposure to the messaging charge. Note that these are averages exhibited on each day and that at various times during the day spreads may be tighter on either market. This graph includes only stocks listed on both markets.

Spreads can be seen to recover in late March, however, this was in response to a decision by a market maker to ignore the economic imperatives introduced by the scheme on a temporary basis. Continuance of current arrangements could see this decision revisited.



Source: Financial Markets Research Centre

The introduction of the scheme has, as noted, had a further impact on the viability of market operator competition for new markets, as market-making for new markets has been rendered unviable. This directly contravenes the Government's stated objective of supporting market operator competition.

In new markets there is limited trading and hence opportunities to 'earn the spread' for market makers, however, the need to send messages to update orders are the same as for established markets. This leaves new markets vulnerable to increases in charges to messaging that affect market makers.

This risk to market operators is the key negative impact of the current cost recovery design.

A further negative impact is to participants acting as agents. The charge was introduced against the recommendation of the industry at a time when the industry was already under strain. Turnover value decreased by 22% on the ASX in 2012, and this combined with increasing regulatory costs and margin compression meant that market participants were already under substantial financial pressure.

The introduction of a new charge that was difficult for participants to pass through to investors by Treasury created pro-cyclical pressures on the industry.

2. Are there any specific segments of our market that you consider have responded to the current cost recovery arrangements in ways inconsistent with government policy or in a manner detrimental to market quality? Please provide examples to support your answer.

Market participants have responded logically to the arrangements. However, due to the imperatives that accompany the design of the scheme this resulted in market quality degradation in the secondary market discussed above.

This degradation, as distinct from the response itself, is inconsistent with government policy to promote efficient markets and to support the development of market operator competition.

3. Do you consider that a fixed fee on direct market participants reflecting the proportion of cost recovered participant supervision that is attributable to direct market participants better aligns the fee model with ASIC's regulatory costs?

In the context of this response AFMA supports the establishment of a fixed fee on direct market participants to reflect the administration costs that are attributable to smaller participants.

The current fee structure does not properly recognise the fixed costs associated with all participants and this measure would go some way to addressing that oversight.

While the measure is supported we note again the increasing complexity of the cost recovery scheme required to balance out inherent inequities.

4. Do you consider that the proposed fixed fee in the order of \$1,800 per quarter is reasonable? Please explain your answer. If you do not view this proposal favourably, please explain your preferred alternative/s.

Whether the size of the fixed fee is correct is unclear as we do not have enough insight into ASIC's cost base.

Taking the allocation for staff proposed for non-issue specific activities as a given, there may be other costs that should be allocated on a per member basis.

We note that at this size it is unlikely to form a barrier to entry or have any significant distortionary impact.

5. What impact does the proposed approach have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?

Our members have indicated that the fixed fee per quarter at the levels indicated and accompanied by an equal reduction in the costs apportioned to the variable component is unlikely to have any material impact on their business models.

6. Do you consider that the cost recovery arrangement for equities market supervision costs (for ASX listed securities) should be amended so that some non IT costs should be recovered through fees on messages? If not, please explain your preferred alternative.

While there are a range of views on this issue, there is a general concern that market makers that are making a real contribution to market quality should not be prevented from doing so by message charge arrangements.

7. What impact does the proposed approach have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?

The majority view of industry is that this proposal should not proceed without being accompanied by a market maker exemption regime.

Without market maker exemption arrangements, increasing the burden on messages would likely lead to further deteriorations in market quality as participants widen their spreads to reduce the need to adjust their orders and hence lower their message quantity.

8. In your view, have market makers responded to the current cost recovery arrangements in a manner detrimental to market quality? Please provide examples to support your answer.

Market makers as contributors to market quality have reduced the frequency of their messaging to accommodate the increased charges that the Government has levied under the cost recovery arrangements. This is a logical response to the incentives the arrangements create.

9. Do you consider that the cost recovery arrangements for equities market supervision costs (for ASX listed securities) should be amended so that beneficial market making activity (subject to strict eligibility criteria) is subject to a reduced cost recovery levy for message based charges? If not, is there an alternative method to prevent the cost recovery arrangements creating a disincentive to undertaking beneficial market making activity?

While there are a range of views, generally the majority view is that there is support for the amendment of the cost recovery arrangements so that beneficial market making activity, subject to strict eligibility criteria, is subject to a reduced cost recovery levy for message based charges.

We note that repeal of the cost recovery arrangements in total is an alternative and preferable response to address the damaging design of the cost recovery provisions. Further, repeal would remove the need for complicated measures such as an exemption scheme to limit the damage caused by the cost recovery scheme.

There is a need to ensure that to qualify for an exemption to the messaging charges that there is a real and substantial contribution to market quality. There is a need to balance this requirement against the need to allow sufficient flexibility in scheme design to suit the needs of different markets and market operators.

If the scheme is extended to the ASX24 market similar schemes may be appropriate, however, the exact details of what would constitute a real and sufficient contribution to market quality may vary significantly.

10. Do you believe we should recognise beneficial market making in the fees regulations and if so, how do you believe we should set the criteria and conduct the process to define beneficial market making activity?

Were a scheme to be established the industry has supported an approach whereby market operators would negotiate with their participants to create market making schemes. These would be in line with the normal commercial arrangements that already exist for many markets.

The market operator would then have the option to apply to ASIC to have a scheme assessed as one that would qualify market makers for the messaging cost exemption.

ASIC would assess each scheme on its merits to determine if it made a substantial and credible addition to market quality.

Given that there is likely to be variance in the proposal for each particular scheme and for each particular market, ASIC's assessment criteria should be general enough to allow a range of scheme designs to qualify.

International schemes may provide some guidance as to what should be required in order to qualify. ASIC should conduct a survey of domestic and international market making schemes and in-depth discussions with market operators and participants before finalising the principles for approval as an exempt scheme. It would be preferable if ASIC gives consideration to how schemes would work in futures, options, debt and other markets to ensure maximum consistency across markets in the future.

It is appropriate that these schemes be reviewed at least every two years.

There is support from all members for a requirement for sufficient robustness in relation to the scheme criteria. Insufficiently robust criteria may risk the creation of market making schemes specifically for the avoidance of the messaging fee exemption.

11. Should firms that benefit from such a discount or exemption be subject to strict, enforceable obligations? If so, what obligations would be appropriate and how should they be enforced?

As noted the design of the specifics of each scheme should be matters for the market operator and its negotiations with its members. Enforcement of the scheme should also be a matter for the market operator.

Qualification for the messaging exemption should only occur where a participant in a market operator scheme that has been approved by ASIC as qualifying for the exemption has complied in the previous month with their obligations under that scheme according to the market operator for a particular stock.

It is inappropriate for regulators to attempt to enforce market making directly as governments could risk forcing firms into bankruptcy in dislocated markets.

12. What impact would the approach referred to in question (9) have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?

The approach referred to in question (9) is likely to make market making in new or low liquidity markets a viable proposition. It will lead to a small increase in charges for non-market making activities.

13. Do you consider that the cost recovery arrangements should be changed so that fees are fixed by ASIC prior to the start of each billing period? Why/why not?

While there are a range of views, members in general support the fixing of fees by ASIC prior to the start of each billing period. Present arrangements have increased the difficulty in passing through charges in an efficient manner.

14. If you agree with the approach referred to in question (13) what, if any, oversight or safeguard arrangements, including notice periods, would you consider appropriate in relation to this process? If you disagree with the approach referred to in question (13), what alternatives do you believe would be appropriate?

In relation to the arrangements in question (13) fixed fees should not be updated except at quarterly intervals. Fees should be adjusted on an unders and overs basis with notice given at least one month in advance of any estimated rise in charges.

The proposal to allow ASIC 'flexibility' to recover regulatory costs from proponents of market innovation is not sufficiently well defined and is not supported.

The cost recovery program already introduces moral hazard into ASIC's budgeting processes. Care needs to be taken to ensure that this is not made worse by allowing ASIC flexibility to set charges at will as long as the total of those charges fits within their total budget allocation. Given that there is the potential for some approved costs to come in under budget these savings should be passed back to market participants and not absorbed by ASIC through the introduction of additional charges.

Further, cost recovery issues are properly matters for Treasury and not ASIC to determine.

15. If you agree with the changes referred to in question (13), do you agree that ASIC should set the fixed fees on a quarterly basis. If not, what other arrangement would be appropriate?

A quarterly basis is appropriate.

16. Do you agree that participants should be made to pass trade and message fees on to their clients? If so, why is such an arrangement preferable to voluntary pass through of costs?

As noted the cost recovery arrangements have produced significant pressures on market participants. In part this is due to the design of the charges, which have been charged in arrears and directly to brokers without any direct association with end users and as a result are difficult to pass through.

There is significant support from market participants trading on an agency basis for policy changes that will simplify and encourage the pass through of charges to end market users. Measures to this end would assist in reducing the pressures on the industry.

17. What changes would be necessary in order for your business to implement the approach referred to in question (16)? Can you provide estimates of the costs of those changes?

18. What impact would the approach referred to in question (16) have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?

19. Do you consider that the current proposed cost recovery approach for equities market supervision costs (for ASX listed securities) can be extended to the ASX24 market once ASIC's real time market surveillance system receives ASX24 data in real time via the Australian Markets Regulation Feed? If not, please explain your preferred alternative.

Extension of the cost recovery regime to the ASX24 market should not be done without further consultation. There are significant differences with the ASX24 that may need to be considered when deploying a cost recovery regime to ensure unintended consequences are minimised.

20. What impact does the proposed approach have on your business model? Can you provide examples of how the proposed approach would affect your business in dollar terms?

21. Do you consider it appropriate that pecuniary penalties issued by the MDP be applied to the cost recovery figure? If so, please explain why.

There is support within industry for directing the monies raised by MDP fines to reduce the cost recovery load borne by the industry. This would more closely align

arrangements with those that existed prior to the commencement of market operator competition in which these monies were hypothecated for industry education.

While the amounts in question can be modest it would remove the opportunity for the development of any perceptions that disciplinary arrangements were antithetical to market participants rather than existing for the good of the market as a whole. Such a scheme would require careful management of any associated policy issues.

22. Do you consider that the proposed change to late payment fees is more administratively simple and efficient, and easier for billing entities to reconcile? If not, please explain your preferred alternative.

The change to a fixed late payment penalty fee regime for fines is supported by members as administratively simpler and easier to reconcile.

Existing arrangements are overly complex and could present issues for reconciliation.

23. What impact does the proposed change have on your business model? Can you provide examples of how the proposed change would affect your business in dollar terms?

While this change, being restricted to instances of late fee payment, would be unlikely to significantly impact business models, it is a straightforward and appropriate approach to late payment.

24. Do you consider that the sanctions for late payments of cost recovery fees should be expanded? If so, what sanctions do you believe are appropriate?

The proposed sanctions of licence suspension and revocation for late payment of cost recovery fees are, as noted in the *Paper*, very substantial and may result in significant impacts for affected firms and their clients. As such, should such a system be implemented it is important that any such actions should only occur in relation to a clear and extended period of non-payment, with clear notice given and senior sign-off from an ASIC Commissioner.

25. Do you consider that granting ASIC the power to suspend or revoke an entity's licence may be appropriate under certain circumstances? If so, how should those circumstances be defined? What safeguards would be appropriate in relation to such a power?

Should the Government proceed with measures to allow ASIC to suspend or revoke an entity's licence it is important that these have strict parameters and controls put in place to ensure they are used judiciously.

Conditions that may be appropriate to include may require that an entity:

- has failed to pay cost recovery charges for a period of at least three consecutive quarters (a period of 12 months from the commencement of the first liability); and
- multiple reasonable efforts have been made to contact the firm to request payment by ASIC.

To ensure ASIC internal procedures are escalated to the correct level it may be appropriate to have an ASIC Commissioner sign off on the action before action was taken to suspend or terminate a firm's AFSL or to ban further trading in the event the firm did not have an AFSL.

These requirements should be legislated to ensure certainty for participants.

26. Do you consider that granting ASIC the power to ban an entity from further trading may be appropriate under certain circumstances? If so, how should those circumstances be defined? What safeguards would be appropriate in relation to such a power?

The circumstances should be the same as those in relation to suspension or revocation of licences outlined in the response to question (25).

27. Do you consider that the Fees Act should be amended to provide for the repayment of recovered fees or the adjustment of future fees when ASIC spends less than its budgeted costs? Should the Act provide for just one of these processes or both? Why?

The industry would be pleased to support changes to the *Fees Act* to allow for the easier return of over-recovered fees.

Both a process to directly return money to charged entities and to reduce future fees should be allowed in the amended legislation.

28. What process, repayment or adjustment, is most likely to be efficient to administer? Why?

Returning money directly to participants would be appropriate for significant amounts. A reduction in future fees would be appropriate where the amounts for each entity are smaller.
