

Options for amending the ASIC Market Supervision Cost Recovery Arrangements

Discussion Paper
December 2012

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CONSULTATION PROCESS

REQUEST FOR FEEDBACK AND COMMENTS

This paper seeks stakeholder feedback on a range of options to amend the Australian Securities and Investments Commission (ASIC) market supervision cost recovery arrangements for the period from 1 July 2013 to 30 June 2015.

Submissions should include the name of your organisation (or your name if the submission is made as an individual) and contact details for the submission, including an email address and contact telephone number where available.

While submissions may be lodged electronically or by post, electronic lodgement is strongly preferred. For accessibility reasons, please email responses in a Word or RTF format. An additional PDF version may also be submitted.

All information (including name and address details) contained in submissions will be made available to the public on the Treasury website, unless you indicate that you would like all or part of your submission to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as such in a separate attachment. A request made under the *Freedom of Information Act 1982* (Commonwealth) for a submission marked 'confidential' to be made available will be determined in accordance with that Act.

In addition to seeking submissions, Treasury will be conducting stakeholder consultation meetings in late January 2013. Should you wish to arrange a meeting in relation to the consultation please contact Treasury.

CLOSING DATE FOR SUBMISSIONS: 1 FEBRUARY 2013

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GLOSSARY

APX	Asia Pacific Exchange Limited
ASEFF	Australian Securities Exchanges Fidelity Fund
ASIC	Australian Securities and Investments Commission
ASX	ASX Limited
ASX 24	Australian Securities Exchange Limited
Capex	Capital expense
Chi-X	Chi-X Australia Pty Ltd
CRIS	Cost recovery impact statement
DoFD	Department of Finance and Deregulation
EMS	Enhanced Market Supervision
Fees Act	<i>Corporations (Fees) Act 2001</i>
FEX	Financial and Energy Exchange Limited
FIDA	Financial Industry Development Account
HFT	High frequency trading
IMB	IMB Ltd
IMSS	Integrated Market Surveillance System
MDP	Markets Disciplinary Panel
MIRs	Market integrity rules
NGF	National Guarantee Fund
NSX	National Stock Exchange of Australia
Opex	Operating expense
SIM	SIM Venture Securities Exchange Limited

PART A: OVERVIEW

SCOPE AND BACKGROUND

Scope

This consultation paper seeks comment on potential amendments to the ASIC market supervision cost recovery arrangements (contained in Part B of this discussion paper) for the period from 1 July 2013 to 30 June 2015, which will enable the Government to recover over the 24-month period:

- costs incurred by ASIC in the performance of its market supervision functions and the implementation of market competition; and
- costs associated with the Enhanced Market Supervision (EMS) measure announced at the 2012-13 Budget¹ to replace its integrated market surveillance system (IMSS), enhance its market surveillance and supervision systems and tools, and deliver improvements to those ASIC portals and registers accessed by market participants.

The cost recovery arrangements extend to the following domestic licensed financial markets:

- Cash equities markets (for ASX listed securities):
 - The following ASX Limited (ASX) electronic order books:
 - : TradeMatch, the current ASX order book; and
 - : Purematch.
 - Chi-X Australia Pty Ltd (Chi-X).
- Small financial markets²:
 - National Stock Exchange of Australia Limited (NSX);
 - SIM Venture Securities Exchange Limited (SIM);
 - IMB Ltd (IMB); and
 - Asia Pacific Exchange Limited (APX), which is working to re-launch in late 2012 or early 2013.
- Futures markets:
 - Australian Securities Exchange Limited (ASX 24) (formerly Sydney Futures Exchange);
 - Financial and Energy Exchange Limited (FEX), which is working to launch in late 2012 or early 2013.

1 Budget Measures 2012-13, Budget Paper No. 2 – Part 2: Expense Measures, Commonwealth of Australia, May 2012, p.277.

2 Under the Corporations (Fees) Regulations 2001, small markets are grouped into a specific market segment. There are currently four markets in this segment.

All amendments discussed in the paper are preliminary and subject to consideration by ASIC, Treasury and the Department of Finance and Deregulation (DoFD). Proposed amendments will be considered against the Government's cost recovery guidelines (discussed below). The information provided in response to this paper will inform this consideration.

Background

Transfer of supervision to ASIC and the Introduction of Competition

As a first step towards the introduction of competition between markets for trading in listed shares in Australia, responsibility for market supervision transferred to ASIC on 1 August 2010.

Funding was approved in the *Mid-year Economic and Fiscal Outlook 2009-10*³ to support the transfer of supervision and expand ASIC's capabilities to undertake its new regulatory role. The Government also announced that the additional expenditure incurred by ASIC would be subject to cost recovery through the imposition of fees on industry.

ASIC's additional responsibilities following the transfer of supervision specifically include:

- undertaking real-time market surveillance and post-trade analysis to detect market misconduct (that is, breaches of the market integrity rules (MIRs));
- monitoring compliance with the MIRs by regulated entities; and
- administering the disciplinary framework for breaches of the MIRs (including the markets disciplinary panel (MDP), enforceable undertakings and infringement notices).

In order to implement the Government's market competition policy, ASIC's regulatory infrastructure capabilities have been enhanced through:

- development of a regulatory framework to apply on the entry of competition;
- upgrade of its IMSS capability to enable the real-time surveillance of the Chi-X market, and to handle multi-market and whole-of-market surveillance and supervision; and
- increase to the number of its market supervision staff in order to:
 - manage the expected increase in market activity and complexity, as well as for the supervision of multiple markets;
 - identify, investigate and take enforcement action against new forms of market misconduct arising from the introduction of market competition; and
 - undertake on-going review and analysis of the market micro and macro structure and the regulatory framework to respond to new issues and market developments.

3 Mid-year Economic and Fiscal Outlook 2009-10, Appendix A: Policy decisions taken since the 2009-10 Budget, Commonwealth of Australia, November 2009, p.216.

Funding was approved in the *Budget Measures 2011-12*⁴ to cover the additional costs required by ASIC to enhance its regulatory infrastructure. This funding was also approved subject to cost recovery from industry.

Chi-X Australia (the first competitor for trading ASX-listed shares) commenced operations on 31 October 2011.

Enhanced market supervision

The EMS measure announced at the 2012-13 Budget provides the Australian Securities and Investments Commission (ASIC) with maximum funding of \$43.7 million over four years to replace its IMSS, enhance its market surveillance and supervision systems and tools and deliver improvements to those ASIC portals and registers accessed by market participants.

The contract for ASIC's existing IMSS (supplied by SMARTS Market Technology) expires in June 2013. ASIC's strategy was to initially implement proven, low-risk technology, then go back to the market for a higher capacity solution once the market supervision function was firmly established at ASIC. ASIC expected that increasing fragmentation, and growth in algorithmic trading including high frequency trading (HFT) occurring in all major markets would mean a generational leap in the available technology when it next went to tender for a system. ASIC also anticipated that several emerging providers of market surveillance technology would have more mature product offerings that had made some inroads into this market, thus there would be several live implementations on which ASIC could conduct extensive vendor reference checks.

The funding for the IMSS upgrade and enhancing ASIC's market surveillance and supervision systems and tools provides for:

- greater capacity and capability (including coping with the increase in algorithmic trading including HFT which now accounts for 25-30 per cent of trades);
- superior capabilities to search data records and identify suspicious trading, by connecting patterns and relationships, which is essential for detecting insider trading relationships; and
- improved post-trade surveillance capability to identify market trends, patterns of trading behaviour and repeated/systemic behaviour.

The approximate breakdown of expenditure between capital expense (Capex) vs. operating expense (Opex) for the entire EMS budget measure is included in Table 1 below. These figures are maximums and are subject to the outcome of the tender process.

Table 1 — Approximate breakdown of EMS costs 1 July 2012 to 30 June 2016

	Capex (\$m)	Opex (\$m)
Total IT costs	15.8	21.8
Total Non-IT costs	0.5	5.6
TOTAL EMS NPP COSTS	16.3	27.4

4 Budget Measures 2011-12, Budget Paper No. 2 – Part 2: Expense Measures, Commonwealth of Australia, May 2011, p.319.

The largest single expense provision is for the replacement and upgrade of the IMSS. Longer term ongoing EMS funding is a maximum of \$4.5 million per annum from 2016-17 onwards.

The funding will be fully recovered through a combination of additional fees on industry and contributions from the Financial Industry Development Account (FIDA). Under the Corporations Act, the excess funds in the National Guarantee Fund (NGF) can be used for funding initiatives that are designed to improve the regulation and operation of financial markets via a FIDA contribution. This is subject to there being sufficient excess funds in the NGF.

The Government has taken steps to ensure that future fee levels remain reasonable. These steps include:

- extending EMS cost recovery of capex over a longer period of time (seven years) rather than capex being recovered within the forward estimates of the Budget measure;
- FIDA contributions having the effect of reducing the fee burden on industry; and
- smoothing/delaying the cost recovery of opex within the forward estimates of the Budget measure to 2014-15 and especially 2015-16. (In 2015-16 market competition cost recovery significantly reduces with the cessation of deferred market competition implementation costs.)

As ASIC is currently procuring the IMSS upgrade, expected future market supervision costs cannot be released at this point in time. ASIC's market supervision cost recovery budget estimates for the expected duration of the next cost recovery period will be published in the draft Cost Recovery Impact Statement (CRIS) in January 2013 and updated as appropriate in 2013 until the fees regulations are settled. See page 21 for more details about the expected release of the first draft CRIS.

Australian Government Cost Recovery Policy

In December 2002, the Australian Government adopted a formal cost recovery policy to improve the consistency, transparency and accountability of its cost recovery arrangements and promote the efficient allocation of resources. The policy applies to all *Financial Management and Accountability Act 1997* agencies and to relevant *Commonwealth Authorities and Companies Act 1997* bodies.

The Government's Cost Recovery Policy requires that cost recovery arrangements must be compliant with the Australian Government Cost Recovery Guidelines (Cost Recovery Guidelines) and all significant cost recovery arrangements must be subject to a CRIS. Cost Recovery Policy is administered by DoFD. Individual portfolio ministers are ultimately responsible for ensuring agencies' implementation and compliance with the Cost Recovery Guidelines.

A core principle of the Cost Recovery Guidelines is that entities should set charges to recover all integral costs of products or services where it is efficient and effective to do so, where the beneficiaries are a narrow and identifiable group and where it would not be inconsistent with Australian Government policy objectives, while undertaking an appropriate level of consultation with stakeholders.

In the case of regulatory activities, the Cost Recovery Guidelines require regulatory agencies to recover the costs they incur (in undertaking their regulatory activities) from the entities

that have created the need for regulation. Charging the regulated firms is usually the most practical approach to setting cost recovery charges.

Cost recovery arrangements must reflect the cost drivers for undertaking regulatory activities. The policy states that 'regulatory agencies may have insufficient information to formulate prices that reflect those cost drivers precisely; therefore, an agency will often need to use a proxy for the costs attributable to a particular industry'. ASIC has used such a proxy in allocating the costs associated with supervising its regulated entities.

Cost recovery is different from general taxation in that there must be a direct link between an agency's costs and the revenue it receives from its charging arrangements. Importantly, cost recovery should not give rise to an over or under collection during the life of the cost recovery arrangement. By contrast, general taxation represents a compulsory exaction of money by a public authority for public purposes that need not bear any correlation to the costs and is not a payment for services rendered.

For the purposes of the Policy, costs may be recovered by way of a fee for the product or service (including regulation), or a levy, whichever is more efficient.

The Government will seek to recover ASIC's market supervision costs for the period from 1 July 2013 to 30 June 2015 through the imposition of levies on:

- operators of the domestic licensed financial markets outlined in section 1.1;
- the market participants of domestic licensed financial markets within the cash equities segment; and
- the market participants of the ASX24 futures market.

CURRENT COST RECOVERY ARRANGEMENTS (1 JANUARY 2012 TO 30 JUNE 2013)

The current cost recovery arrangements came into effect on 1 January 2012 and will expire on 30 June 2013. Prior to this date costs were recovered through a combination of fixed fees and contributions from the NGF and the Australian Securities Exchange Fidelity Fund (ASEFF).⁵

The total cost to be recovered from industry for the 18 month duration of the current cost recovery period (from 1 January 2012 to 30 June 2013) is approximately \$29.8 million. Approximately \$14.7 million of this relates to the transfer of supervision from ASX to ASIC and around \$15.1 million relates to market competition.

The current cost recovery arrangements differ from previous arrangements in order to reflect the new competitive environment in the cash equities market. This difference results in the arrangements more accurately reflecting the Government's Cost Recovery Guidelines, which require that the individuals or groups that have created the need for regulation should bear the cost of that regulation. Both market operators and market participants drive ASIC's regulatory costs.

5 The use of excess monies from the NGF and ASEFF was an interim measure for transfer of supervision costs incurred prior to the commencement of competition as referred to in the related cost recovery impact statements:

<http://www.asic.gov.au/asic/ASIC.NSF/byHeadline/Market%20supervision%20and%20surveillance#cris>.

ASIC's cash equities market supervision costs are allocated between market operators and market participants by reference to categories of ASIC's market supervision functions, as follows:

- costs identified as relating to the regulation of market participant activities are allocated to market participants only;
- costs identified as relating to the regulation of activities of both market operators and market participants are allocated to both groups based on a proxy that reflects each group's share of overall industry revenue; and
- costs associated with implementing market competition (that is ASIC's IT and regulatory framework deferred implementation costs) are allocated between market operators and market participants in equal proportion (that is 50:50).

Both ASX and Chi-X are charged a proportion of their allocation as a fixed fee per quarter. Both markets are also charged a quarterly variable fee based on each entity's share of the trade count and message count in ASX listed securities during each quarter. Market participants are solely charged a quarterly variable fee based on each entity's share of the trade count and message count in ASX listed securities during each quarter.

To reflect the different drivers of ASIC's non-IT and IT cash equities market supervision costs, these costs in relation to participants (for the period from 1 January 2012 to 30 June 2013) are proportionally allocated to each participant as follows:

- non-IT costs are proportionally allocated based on the number of transactions; and
- IT costs are proportionally allocated based on the number of messages.

A fixed fee covering the cost of supervision is charged to small markets (markets other than ASX and Chi-X) and to ASX24.

Feedback Sought

- (1) Do you consider that the impact of the current cost recovery approach on overall market quality⁶ has been (a) mostly neutral, (b) positive, (c) negative or (d) other? Please provide examples to support your answer.
- (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.

TIMING OF IMPLEMENTATION

Irrespective of whether any substantial changes to current cost recovery arrangements are approved, a new CRIS and an update to the *Fees Regulations* are both required to be in place prior to 1 July 2013 as the current:

⁶ Dimensions of market quality include: market liquidity, price formation, depth, execution time and cost, volatility and the ability of market/s to handle stress and liquidity shocks.

- CRIS expires on 30 June 2013; and
- *Fees Regulations* are based on an ASIC budget for the period 1 January 2012 to 30 June 2013.

Any changes to the fee model must be agreed by the end of March 2013 so that there is sufficient time to prepare and process the new CRIS and *Fees Regulations*. Changes to the fee model are subject to several Government approval processes, including one confirming adherence with Government's cost recovery guidelines.

Draft amendments to the *Fees Regulations* and a draft CRIS are expected to be released in early 2013.

PART B: POTENTIAL CHANGES TO THE COST RECOVERY ARRANGEMENTS

INTRODUCTION OF A FIXED COMPONENT OF COST RECOVERY FOR CASH EQUITY MARKET PARTICIPANTS

ASIC's Market & Participant Supervision team allocates 20 of its staff to conducting reviews of direct and indirect market participants. The aim is for these staff to spend half their time on non-issue specific, general reviews of participants and the other half in more in-depth follow-up reviews and remediation activities.

The former activity lends itself to cost recovery via a fixed fee per direct market participant as this regulatory activity is independent of the level of trading activity of direct market participants. The current cost recovery approach is wholly variable with respect to trading and order messaging activity. The fixed fee approach better reflects the significant investment in regular, ongoing monitoring and supervision that ASIC undertakes for every direct market participant/Trading PID⁷.

The fixed fee proposed is in the order of \$1,800 per quarter per Trading PID (all figures are rounded to the nearest hundred dollars), based on the following assumptions and preliminary workings:

- average fully loaded staff cost p.a. of \$135,000⁸;
- 60 per cent of the salaries and wages of this team are subject to cost-recovery (with the remainder funded from ASIC's core budget appropriation that is not subject to cost recovery); and
- 70 per cent of the reviews are conducted on direct market participants, with a current regulated population of c. 80 – 90 market participants/unique Trading PIDs.

The workings are as follows:

$$\frac{\$135,000 \times 20 \times 50\% \times 60\% \times 70\%}{80} = \$7,088 \text{ p.a.} = \$1,771.88 \text{ per quarter} \\ = \$1,800 \text{ per quarter (rounded)}$$

Under this proposal, variable per trade and per message cost recovery fees would then be applied in addition to the fixed fee in order to recover the remaining costs attributed to cost recovered activities.

Feedback Sought

- (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?

7 Trading PIDs are unique identifiers that tag a market participant's identity to every trade side and order on a market.

8 The figure proposed here is based on a sample size larger than twenty that includes these and similar staff in ASIC's Markets cluster, and should therefore be relatively stable over the cost recovery period.

- (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.
- (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?

CHANGES TO VARIABLE FEE COMPONENTS

Increased messaging fees — Inclusion of Operational costs into messaging fees

The current cost recovery model was designed in an environment where trades rather than orders were driving most of the staff costs for ASIC's market supervision operational work; whereas messaging fees predominantly drove ASIC's market supervision IT costs.

At that time, detecting and prosecuting market abuse caused by trades was ASIC's highest priority, although some work did arise from orders – for instance disruptions caused by HFT. However, since the current fee model was designed there has been a significant increase in the amount of time spent by ASIC's staff working on issues related to increased algorithmic trading including HFT. Specifically:

- a substantial increase in algorithmic trading including HFT – incorporating not only increased trading volume, but increased cancelled orders and messages for each transaction executed – has led to a general increase in ASIC's workload:
 - HFT now accounts for 25-30 per cent of all lit market transactions, and the high order-to-trade nature of HFT means it accounts for a substantially higher share of orders and messages than more traditional trading strategies do;
- more brokers support HFT clients, adding to ASIC's work on certification and dealing with issues arising from varying degrees of brokers' experience in this field;
- an increase in HFT-related issues arising which then flow through to ASIC's market integrity deterrence teams; and
- an increasing need for further analysis into the impact of HFT on market integrity and efficiency and potential policy responses.

In keeping with the requirement in the cost recovery guidelines that cost recovery arrangements should reflect the cost drivers of the activity, it may be appropriate for some staff costs to be allocated through a message based fee rather than as they are currently, which is through the trade based fee. The majority of ASIC's non-IT costs would continue to be allocated according to transactions.

Feedback Sought

- (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.

- (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?

Market maker discounts

Some stakeholder feedback has raised the question of whether the current cost recovery arrangements have unintended consequences for market efficiency. In particular concerns have been raised about the impact of cost recovery on competition and on market making possibly negatively impacting market efficiency. Market making is the offering of both a bid and offer on a security with the aim of profiting from the spread between the two prices, usually over a timeframe of a trading day. However, in order to be able to manage their risk exposure market makers automatically amend (or cancel and re-enter) their orders to reflect new prices as they change. One of the effects of the increasingly fast changes in bid and offer prices on the market over the past five or so years is that market making generates many more orders now compared to the past.

Continuous, two-way market making is generally viewed as beneficial as it helps reduce imbalances between buy and sell orders and reduces risk for investors by providing a ready counterparty, increasing the likelihood that a trade will occur⁹. Market makers are also important for facilitating market competition, as they reduce the search costs between markets. This gives algorithmic arbitrage traders the opportunity to identify and take advantage of better prices and lower fees available on emerging exchanges, generating activity for that new exchange and creating further liquidity for the competitor¹⁰. This is particularly relevant in the Australian market, with some HFTs acting as market makers for Chi-X.

Therefore it is preferable that the cost recovery arrangements do not create a disincentive to undertaking market making activity where such activity is beneficial (that is it assists in developing a market or market segment or otherwise improves one or more dimensions of market quality for a market or market segment). One option that could be considered would be to offer a reduction in the cost recovery levy, or perhaps even exempt continuous, two-way market making activity from message based charges, subject to strict eligibility criteria and ongoing evaluation and measurement that the market maker is meeting its market making obligations. Robust, enforceable arrangements are necessary to distinguish beneficial market making activity from other styles of market making.

Also under consideration is an additional fixed fee for these market makers if ASIC's supervisory model for market makers involved some aspect of resources dedicated to this segment.

Any discount or exemption would have to be carefully evaluated against the cost recovery guidelines as well as the above policy considerations. Such a discount or exemption would have the effect of reducing the costs that are recovered from some firms who conduct market making, leading to an increase in the burden which would be placed on other firms, such as institutional traders and non-market making HFT. The information provided in response to

9 The Value of the Designated Market Maker, Kumar Venkatamaran and Andrew C. Waisburd, *Journal of Financial and Quantitative Analysis*, Vol 42, No. 3, Sept 2007.

10 High frequency trading and the New Market Makers, Albert J Menkveld, VU University Amsterdam, 6 February 2012.

this discussion paper will be used to undertake an analysis of that impact and determine whether there is a compelling policy case for introducing a discount or exemption.

Feedback Sought

- (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.
- (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?
- (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?
- (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?
- (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?

Fixing of charges in advance

One concern that industry has expressed about the current cost recovery arrangements is the difficulty in estimating costs when fees per message or trade are not fixed at the start of the billing period. The current cost recovery arrangements were designed so ASIC would not over or under recover costs by a substantial amount. However, one consequence of the arrangements is that the cost of each message or trade is not certain at the time it is entered/executed. Fixing these fees would provide greater certainty to industry and also facilitate simpler pass-through of such fees to end users. On the other hand, fixing a fee per message or trade increases the risk of significant over- or under-recovery by ASIC.

A potential solution might be to set fixed fees on a quarterly basis taking into account probable trading conditions. This would allow ASIC to adjust fees up or down each quarter during a cost recovery period to accommodate over- or under-recovery from the previous quarter. Such an arrangement would raise the issue of how to ensure appropriate safeguards or oversight arrangements. For instance procedural requirements may be necessary, such as providing industry with sufficient notice of the quantum of fees.

It is also proposed that the arrangements provide for flexibility to recover ongoing regulatory costs incurred by ASIC to regulate significant innovations to the market from the proponents of such innovations, within the maximum recovery amounts set out in the budget. Examples include (but are not limited to): the introduction of new trading platforms; the introduction of new market operators; an extension of trading hours by a market operator.

Feedback Sought

- (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?
- (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?
- (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?

Mandatory pass through

Some participants have expressed concerns that under the current cost recovery arrangements the costs of supervision might not be passed through to clients, meaning the correct regulatory price signals are not received by end users. These participants have suggested that due to competitive broking conditions and the proliferation of direct market access (where clients input their own orders onto the market through a participant's infrastructure) it is difficult for such a pass through to occur.

An option that has been suggested is for the Government to mandate that participants pass the trade and message fees on to their clients. Participants would then collect the fee from clients and pass the fees on to ASIC. In order for such an arrangement to be possible trades and messages would need to have moved to a fixed fee model as discuss above.

Significant issues would be faced in proceeding with such a proposal. The passing on of regulatory costs is usually considered a commercial decision for each firm. There is a serious question as to whether it would be appropriate for the Government to mandate this aspect of commercial activity by the private sector. Mandatory pass through of a trade and message based fee would also require that brokers be able to track how many trades and orders each client has placed. There may be significant implementation costs for industry in establishing systems capable of allocating orders to particular clients.

Feedback Sought

- (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?
- (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?

CHANGES TO ASX 24 COST RECOVERY

When new *Fees Regulations* commence on 1 July 2013 it is likely that ASX24 trading will be supervised using current processes that are predominantly based on supervision which

occurs one day after trades are executed, in contrast to the real-time supervision which occurs on cash equities markets.

However, during the 2013-14 FY that the new *Fees Regulations* will span this is expected to change and ASX24 data will be incorporated into ASIC's real-time market surveillance system.

At that time, we would propose replicating as closely as practicable the general approach for equities cost recovery proposed in this paper to ASX24 – namely, that futures market participants commence paying market supervision levies to ASIC in addition to the market operator. An appropriate methodology to determine how to apportion cost recovery between ASX24 and futures market participants would need to be implemented.

Based on our current proposal, futures market participants would pay:

- a fixed cost recovery fee per quarter reflecting the base cost of ASIC's futures market participant supervision;
- a variable message-based fee to recover ASIC's ASX24 specific IT costs and for internal resources working on regulatory and policy work on advanced electronic trading in the ASX24 market; and
- the balance of ASIC's costs would be allocated variably according to futures market trades.

Feedback Sought

- (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.
- (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?

COST RECOVERY AND PENALTIES FOR BREACHES OF MARKET INTEGRITY

The MDP is an independent peer review body delegated to make decisions about whether to issue infringement notices or accept enforceable undertakings for alleged breaches of the ASIC market integrity rules. The MDP may impose a pecuniary penalty that must not exceed three-fifths of the penalty set out under the ASIC market integrity rules in relation to that rule, where it finds that the rule has been breached. The MDP model is generally based on the ASX Disciplinary Tribunal, the forum for previous disciplinary action taken by the ASX against participants for alleged breaches of the ASX Market Rules, amongst other ASX operating rules.

Where the MDP issues an infringement notice imposing a pecuniary penalty, it states that the penalty is payable to the Commonwealth¹¹. Where the MDP accepts an enforceable undertaking that includes an undertaking to pay a specified amount, then that amount is

¹¹ Subregulation 7.2A.02 (1)(a) of the *Corporations Regulations 2010* (Cth).

also payable to the Commonwealth¹². Some stakeholders have requested that revenue collected as pecuniary penalties issued by the MDP should be applied against the amount to be cost recovered from industry.

Since the MDB was established on 1 August 2010 it has issued eight infringement notices. Two infringement notices were issued in calendar year 2011 imposing a total of \$55,000 in pecuniary penalties. At the date of publication of this discussion paper, six infringement notices had been issued in calendar year 2012 imposing a total of \$277,000 in pecuniary penalties.

The penalties imposed by the ASX Disciplinary Tribunal for the calendar years 2005 to 2010, are generally indicative of the sort of variation in revenue that the MDP.

The total ASX penalties for the calendar years concerned were:

2005 – \$40,000

2006 – \$32,000

2007 – \$474,500

2008 – \$755,000

2009 – \$1,880,000

2010 – \$1,225,000¹³

For the purposes of the Cost Recovery Guidelines fines and pecuniary penalties are not considered cost recovery. Revenue from fines or pecuniary penalties is not generally used to fund activities subject to the Cost Recovery Guidelines.

Any proposal to apply pecuniary penalties will need to be carefully evaluated against the cost recovery guidelines and require an explicit decision by Government. The information provided in response to this discussion paper will be used to undertake an analysis of this proposal and determine whether there is a compelling policy case for introducing the exemption.

Feedback Sought

- (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.

¹² Subregulation 7.2A.02 (1)(c) of the *Corporations Regulations 2010* (Cth).

¹³ The ASX Disciplinary Tribunal operated from until 1 August 2010. The MDP was established on 1 August 2010, however, did not issue any infringement notices for the remainder of the calendar year.

COLLECTION AND ADMINISTRATION OF FEES

Sanctions for non-payment of fees

Changes to late payment fees

Late payment fees are not cost recovery fees and are therefore outside of the market supervision cost recovery arrangements. However, whether late payment fees are adequate to ensure timely payment of cost recovery fees is relevant to the efficient operation of the cost recovery process. ASIC is considering whether late payment fees regulations that operate similarly to other Corporations Act late payment fees may be more administratively simple and efficient, and easier for billing entities to reconcile.

At present, Regulation 9 of the Corporations (Fees) Regulations 2001 imposes fees for late payment on the balance of any unpaid and overdue ASIC market supervision fees that are determined by multiplying the amount of the unpaid fee by 20 per cent per annum, calculated daily and charged twice monthly on the 6th and 20th of each month. Late fees apply where market supervision fees remain unpaid 60 days after the quarterly fee liability is incurred.

An alternative proposal would be to apply late fees where market supervision fees remain unpaid once a fee liability for a subsequent quarter is incurred and that, rather than applying a daily late fee for each day fees remain unpaid, a fixed fee apply immediately once fees become overdue.

An additional late payment fee would then be applied for market supervision fees that remain unpaid once a second subsequent quarterly fee liability is incurred. After this period, further sanctions for continued non-payment would be considered (discussed in the section *Other Sanctions* immediately below).

Under this proposal the fixed fees would be tiered according to the amount of unpaid market supervision fees as outlined in the table below:

Amount of unpaid market supervision fees		Fixed late payment penalty fee for fees remaining unpaid once the next quarter's fee liability is incurred	Additional fixed late payment penalty fee for fees remaining unpaid once a second subsequent fee liability is incurred
Greater than	Less than or equal to		
\$0	\$10,000	\$150	\$250
\$10,000	\$50,000	\$300	\$500
\$50,000	\$100,000	\$1,200	\$2,000
\$100,000	Max fee	\$2,400	\$4,000

Feedback Sought

- (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.
- (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?

Other sanctions

There are concerns that the purpose of the market supervision cost recovery arrangements could be undermined by difficulties in enforcing the collection of its market supervision fees from foreign participants. In the case where a foreign participant (who may or may not require an Australian licence) consistently does not pay Australian market supervision fees, ASIC may need to incur what could be relatively high costs to recover its fees (for example obtaining advice on dealing with foreign laws, accessing assets and enforcing court orders).

Currently the only sanction available to ASIC in the case of late payment of market supervision cost recovery fees is late payment fees. Prior to the transfer of secondary market supervision to ASIC on 1 August 2010, ASX as the single market operator required prompt payment by market participants for trading fees to ensure their continued access to the market. Arguably the current system does not provide the same level of incentives to ensure timely payment of cost recovery fees.

One option would be to give ASIC the power to temporarily suspend or even revoke the licence of an entity under certain circumstances. Such a power would significantly discourage the late payment of fees. However, the consequences for the entity and their clients could be extreme.

For this reason the circumstances under which such a power could be exercised would need to be clearly defined and appropriate safeguards against overuse would need to be established. For instance, the power could be such that ASIC could only exercise it if payment was overdue by a certain length of time (for instance once two fee liabilities had been incurred subsequent to the overdue fee) and the entity had been contacted in relation to the payment a certain number of times. Additionally ASIC could be required to give adequate notice, allow the entity to be heard (or the decision to be appealed), or allow the unwinding of positions over time. Unfortunately, in the case of overseas participants who do not require an Australian licence, this sanction would be ineffective.

Therefore, one option may involve giving ASIC the power to ban an entity from any further trading on Australian markets until outstanding fees are paid, but to leave the entity's Australian recognition (for example a market licence otherwise unchanged. This option may be less disruptive to entities and clients, particularly clients of participants on a derivatives exchange. This option would also require clearly defined circumstances for when it could be exercised and appropriate safeguards against improper use.

Feedback Sought

- (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?
- (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?
- (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?

Provision for repayment of over-recovered fees

Currently under the *Corporations (Fees) Act 2001 (Fees Act)* there is no provision for the repayment of recovered fees or adjustment of future fees if ASIC should under spend in any period. Processes exist for such repayments and adjustments to occur (for instance through s.28 of the *Financial Management and Accountability Act 1997*), however, it may be beneficial for the *Fees Act* to specify the process through which any underspend be re credited to industry. For instance, the *Fees Act* could be amended to provide for ASIC to either repay amounts to the charged entities, or to provide adjustments to future fees that may be charged to those entities, or both.

Feedback Sought

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

PART C: NEXT STEPS AND FEEDBACK

NEXT STEPS

Section 6A of the *Fees Act* states that a fee for a chargeable matter may be prescribed under the *Fees Regulations* by specifying a fee amount. Alternatively it may be prescribed by specifying a method for calculating the amount of the fee.

As described in the section Timing of Implementation commencing on page 8, the current *Fees Regulations* will cease to operate on 30 June 2013. The *Fees Regulations* will be amended prior to 1 July 2013 in order to incorporate new cost recovery arrangements as determined appropriate under the Government's market supervision cost recovery guidelines.

Other changes to the arrangements may require legislative amendments. The responses to this discussion paper will help inform whether any legislative reform is necessary.

Table 2 — Indicative Timeline

Submissions to Discussion Paper close	1 February 2013
Draft CRIS released	February – March 2013
Draft of regulations released	February – March 2013
Consultation closes on draft regulations	March – April 2013
CRIS reviewed by the Expenditure Review Committee of Cabinet	April – May 2013
CRIS published	June 2013
Amended cost recovery arrangements commence	1 July 2013

Further consultation

Industry comments on this consultation paper will inform the development of the *Fees Regulations*. An exposure draft of the *Fees Regulations* will be released for public comment in 2013.

Cost recovery impact statement

Under the Australian Government's Cost Recovery Guidelines all agencies with significant cost recovery arrangements are required to prepare a CRIS. Your comments on this consultation paper will inform the development of the CRIS for the period 1 July 2013 to 30 June 2015.

A CRIS reflecting the final cost recovery arrangements will be published on the ASIC website before the amendments to the *Fees Regulations* giving effect to the new cost recovery arrangements come into effect on 1 July 2013.

SUMMARY OF FEEDBACK SOUGHT

This consultation paper seeks comment on potential amendments to the ASIC market supervision cost recovery arrangements (contained in Part B of this discussion paper) for the period from 1 July 2013 to 30 June 2015. An index to these questions and the context in which they have been posed is provided below.

Section	Feedback questions	Page
Current cost recovery arrangements (1 January 2012 to 30 June 2013)	(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.	8
	(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.	8
Introduction of a fixed component of cost recovery for cash equity market participants	(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?	11
	(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.	12
	(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?	12
Changes to variable fee components	(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.	12
	(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?	13
	(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.	14
	(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?	14
	(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?	14
	(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?	14
	(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?	14
	(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?	15

Section	Feedback questions	Page
	(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?	15
	(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?	15
	(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?	15
	(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?	15
	(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?	15
Changes to ASX 24 cost recovery	(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.	16
	(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?	16
Cost recovery and penalties for breaches of market integrity	(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.	17
Collection and administration of fees	(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.	18
	(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?	18
	(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?	19
	(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?	19
	(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?	19
	(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?	20
	(28) What process, repayment or adjustment, is most likely to be efficient to administer? Why?	20

