Stockbrokers
Association of Australia
Incorporating SDIA

1 February, 2013

The Manager,
Financial Markets Unit
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The Treasury
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By email: financialmarkets@treasury.gov.au

Dear Sir/Madam

OPTIONS FOR AMENDING ASIC MARKET SUPERVISION COST RECOVERY ARRANGEMENTS – DISCUSSION PAPER
COMMENTS BY STOCKBROKERS ASSOCIATION OF AUSTRALIA

The Stockbrokers Association of Australia Limited ("the Stockbrokers Association") appreciates the opportunity to provide these comments on the Discussion Paper "Options for Amending ASIC Market Supervision Cost Recovery Arrangements".

Set out below are some General Submissions which are made before addressing the specific Questions set out in the Discussion Paper.

GENERAL COMMENTS

The Stockbrokers Association has consistently argued that the application of Cost Recovery for ASIC Market Supervision Costs, and the form in which it has been applied, would be seriously detrimental to Australia's Equity Markets.

The experience of cost recovery in is first cycle of operation has borne out the Association's fears. The financial burden that has been carried by the market, and largely by stockbrokers, has been significant.

As we predicted, brokers have not been in any position to pass the levy on for reasons of competition and the continuing reduced demand for equities as a class of investment. Instead, brokers have carried the cost burden themselves, and dealt with this cost by cutting cost, most noticeably in the area of staff. Undoubtedly, there have been many staff who have been laid off as a direct result of cost recovery. The financial position of stockbrokers has been further undermined by being in direct competition with entities who are not subject to the cost recovery burden, most notably "shadow" brokers, who consequently have acquired a better competitive position as a result.

In terms of the Government policy of fostering Australia as a regional financial centre, and creating jobs for Australians, cost recovery has not contributed to Government policy, rather, it has undermined it.

The issues that are now being sought to be addressed in the Discussion Paper to enhance the model for cost recovery in the next cycle, and some of the practical dilemmas that are raised, are indicative of the failure of cost recovery in policy terms. Our fundamental submission is that cost recovery ought to be dropped. The other comments we make hereafter are made subject to this over-riding submission, and should be considered in this light.

Implementing Cost recovery fairly

Further to our above comments, we note that feedback has been sought on whether there should be a carve-out from the messaging component of the cost recovery levy for bona fide market makers.

The Association believes that it is prudent that the liquidity that bona fide market making has the potential to bring to the equities market should not be jeopardized.

We are therefore concerned at feedback from industry to the effect that market makers have been impacted by the message component of the levy. Members have reported that bid offer spreads for market making activity have widened to adjust for the impact of the messaging component of the levy, and also that the size of the positions which market makers have been prepared to take have been reduced.

In our previous submission, we noted that it made no sense to go down the path of introducing competing exchanges, with all of the cost and upheaval that this has

entailed, and then introduce a transaction cost which would threaten to erode some of the key benefits sought to be achieved by the exercise.

Some of the key benefits that were expected to flow from market competition were increased liquidity, narrower spreads and better pricing. The potential role of market makers in linking trading in the two markets is one of the key factors in achieving these objectives. To the extent that cost recovery has adversely impacted on market making activity, it has undermined the strategy of introducing market competition. Given the extent to which the Chi-X market, in its establishment phase, is likely to be reliant on the activity of market makers for turnover, there is the potential that cost recovery could be acting to weaken the competing exchange before it has fully established itself. The Association is very concerned that the introduction of market competition is a success.

Having said this, there were strong views expressed that cost recovery should not be an interventionist tool that favours one form of commercial activity over others. The fundamental principle that should apply to cost recovery wherever it is imposed is that if costs are genuinely incurred in relation to certain regulatory activity, then the costs should be applied fairly to all relevant parties, and not applied in a discriminatory way. Cost recovery should not be a tool to encourage some forms of activity in preference to others.

Given that a fixed sum is to be recovered from the market, taking the burden off one sector or group of participants will mean the rest of the market pays more. The view was strongly put that it is fundamentally unfair as a matter of principle, regardless of the merits of the activity sought to be encouraged (which in this case, as we have said, we do not disagree with).

In any event, there are many other forms of trading which could equally claim to be beneficial to the market, and having an equal or even superior claim to having been adversely affected by cost recovery, and to warrant being given a carve-out. It is a dangerous development for cost recovery generally for the Government to be making interventionist decisions that create an uneven playing field.

This question serves in our view to reinforce our argument that the appropriate way in which to resolve the undesirable impact of cost recovery on message sensitive trading activity is to dispense with cost recovery for all.

A number of members, on the other hand, were supportive of relief from the messaging component being given to genuine market makers, in recognition of the liquidity that genuine market makers provide, and the impact that a messaging levy could have on that activity given the need to continuously update quotes in the market. This is particularly the case in relation to market makers in products such as derivatives and ETFs.

In extending such relief, a clear distinction would need to be made between genuine market makers, and High Frequency Traders or other proprietary traders who could not be regarded as real market makers. In order to be considered for such relief, market makers would need to satisfy the conditions of an appropriate registered market maker regime that would stipulate their market making obligations, thereby ensuring the benefits to the market. This would also serve to rule out any entities seeking to label themselves as market makers simply in order to get access to the relief.

Spreading the burden of cost recovery more evenly

The Association's position has consistently been that, if cost recovery is to be applied, then the burden should be spread fairly and more widely across all parties who generate the regulatory supervisory activity performed by ASIC.

We note that the next cycle of cost recovery will see the calculation of liability for cost - recovery for ASX24 will be placed on the same level as that for the equities markets. - This is appropriate and in line with our fundamental position above. -
The extent to which this will have any significant impact on the amounts recovered from - individual entities is unclear, particularly given the large increase in the overall $ amount - which is sought to be recovered over the next 4 years. -

The Association is disappointed that there has been no decision to seek cost recovery contributions in the next cycle from listed entities and from "shadow" brokers.

Listed entities are significant beneficiaries of ASIC Market Supervision and of the maintenance of integrity of the equities market. Listed entities benefit in the form of a lower cost of capital from an efficient and fair market for their securities.

Certain ASIC supervisory activity directly stems from activities relating to securities of listed entities. For example, the recent Whitehaven and David Jones cases are examples where ASIC's supervisory activity relates directly to conduct relating to listed securities rather than the activities of any particular market participants. For this ASIC supervisory activity to be paid for by Market Participants alone is not a fair outcome.

Similarly, the Association has argued previously that shadow brokers should be liable for a contribution to ASIC cost recovery. As a sector which gives rise to ASIC market supervision activity, entities in this sector should bear their fair share of cost recovery. The absence of liability for cost recovery at present creates an un-level playing field, and a financial incentive for advisers to consider migrating from being a well-regulated

market participant to the low-regulation "shadow" broking space, hence reducing retail investor protection and undermining government policy.

Lastly, cost recovery should also be applied fully to trading activity on alternative trading venues, including dark pools. At present, the cost recovery model has very limited application to dark pool trading, namely, only in respect of the transaction that is eventually reported to an Exchange. The lack of transparency of orders and messages within a dark pool means that activity which attracts a levy on the lit market is free of any cost recovery burden when conducted on a dark venue.

Applying transaction costs to lit markets and not to alternative venues creates a financial benefit to trading on those venues, which does not create a level playing field. In the context of the ongoing concerns about the level of migration of liquidity from the lit market to dark venues, cost recovery would undermine government policy if it created a financial incentive for that very migration to occur.

Apportionment as between Market Operators and Participants

The apportionment of the overall budget for ASIC's Market Supervision costs as between Market Participants and Market Operators on the basis of revenue has resulted in a split which has not proved to be a fair one. In the first cycle of cost recovery, this resulted in a split of approximately 78%/22%.

Whilst our previous submissions about spreading cost recovery across a broader range of sectors would, if adopted, alter the ratio of the cost recovery burden, the split between Market Operators and Market Participants nonetheless would still remain heavily slanted towards Market Participants and not a fair split, particularly given that there is no real prospect of Market Participants being able to pass the costs on. An alternative method of apportioning a split of the costs should be determined.

Transparency of ASIC Budget processes

We note that some figures have been supplied (Table 1, Page 5) for the approximate breakdown of the ASIC Enhanced Monitoring System (EMS) costing, which is to be recovered in next cost recovery cycles.

This additional detail is helpful, however there is considerable concern amongst members of the Stockbrokers Association that there is remains a lack of transparency of ASIC budget processes, both in relation to the EMS and more generally.

Association Members appreciate that ASIC's existing surveillance system represents outdated technology, and that investment in a new system is needed to properly monitor an increasingly fragmented and technologically complex trading environment.

Notwithstanding this, Members are concerned at being largely responsible for paying the bill for systems where there is little transparency over the process which determines the cost of such systems. This is particularly the case where many Members have considerable experience with system development and budgeting for such systems, which gives them some insight into what such systems ought to cost. The general view that has been expressed by Members is that, based on their experience, and without access to more detail, the budgeted figures in Table 1 appear unduly high.

SPECIFIC SUBMISSIONS ADDRESSING DISCUSSION PAPER QUESTIONS

Current Cost Recovery Arrangements

(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.

(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.

The Associations submissions on these questions are covered in our General Submissions above.

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?

(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?

Subject to our General Submissions above, if the amount of the fixed component represents a fair reflection of the cost of the supervisory activity undertaken in respect of the firm, then this would be in line with the principles that should govern cost recovery.

As we have mentioned, financial conditions are tough across the board, and have been for some time. A fee of the amount foreshadowed would not be easy on firms whose turnover may be very low, and which are therefore the target for such a minimum fee. It is difficult for the Association to comment in more detail on the business model of individual firms, which are likely to differ from case to case.

We note that the Question 3 refers to "direct market participants". An entity is either a market participant or it is not, hence there is no such thing as an "indirect" market participant. If it is intended to draw the distinction between market participants, and other entities such as "shadow" brokers, we refer to our General Submissions above in which we argue that it is appropriate to extend liability for cost recovery to such entities.

If it is appropriate to levy a fixed fee on market participants, then there is equal justification to levy a fixed fee on all other entities who generate ASIC Supervisory activity proportionate to the level of that Supervisory activity, and not just on Market Participants. A further consideration supporting this extension of the regulatory cost burden is ASIC's concerns relating to issues such as the marketing of Contracts for Difference ("CFD's"), which are mainly issued by entities which are not market participants but which generate supervisory activity by ASIC the costs of which presumably are sought to be recovered under the Cost Recovery arrangements

Inclusion of Operational Costs into Messaging Fees

(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?

We refer to our General Submissions on the impact of the messaging component of the levy. It is difficult to comment without knowing more detail as to the amount of the non-IT costs that can properly be attributed to supervision of message related activity, and how much difference this would make to the $ amount of the message component of the levy.

Any difference to the message levy will without doubt need to be factored into the economics of a range of trading that is heavily message dependant, including not only market making, but other activity such as arbitrage. To this end, any change to the message component will have a corresponding impact on those forms of trading.

Having said that, we reiterate as a matter of principle that, to the extent that cost recovery is applied, it should be applied fairly and there should be no cross subsidization of one form of activity by another. If certain supervisory activity, including non-IT costs, can fairly be attributed to one group, then the principle of cost recovery should mean that the cost should be borne by that group.

Market Maker Discounts

(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?

The Associations submissions on these questions are covered in our General Submissions above.

Fixing of Charges in Advance

(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?

Overall, our members would prefer being able to operate with certainty as to the level of the costs applying to their businesses. This favours the amount of the cost recovery levy being set in advance.

Setting the fees in advance would also be essential in order to be able to pass the levy on to clients, although for the reasons we have mentioned, this is not presently seen as being likely in the present circumstances.

Fixing the fees once at the start of the billing cycle does however greatly increase the potential for significant over/under recovery, should trading conditions differ significantly from that predicted. This would particularly be the case where a cycle is a long one, as is the present cycle, namely, 2 years, and where economic and trading conditions are very uncertain, as at present. Few people are confidently predicting the level of trading and message activity over the next 2 years in the current economic climate.

This would suggest that the level of fees should be reviewed more frequently, such as at the start of each quarter. The Association also strongly submits that the level should err on the side of under-recovery rather than over-recovery. Over-recovery would be an

unfair impost on economic activity, and raises the question of how to return the extra amount recovered back to the market in a fair way.

On the other hand, there is no reason for any imperative for the Government to recover ASIC's costs down to the last dollar, and for any shortfall not to be carried by Consolidated Revenue, particularly given that there are many areas of economic and other activity which are not the subject of cost recovery arrangements at all. Hence, if fees are to be set in advance, fee levels should be set erring on the lower side.

Mandatory Pass through

(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?

We refer to the General Submissions made above. A critical flaw in the decision to pursue Cost Recovery against Market Participants for Market Supervision Costs is the assumption that the costs could be passed through. As we have seen, this has been shown to be incorrect.

Our Members consider that it would be unusual for the Government to direct Participants to pass trade and message fees on to clients. There is no precedent for such a direction in any other area of activity, to our knowledge. If it is the Government's ultimate objective that investors and consumers of financial products ultimately pay the cost of market supervision, then the appropriate course would be for the Government itself to impose the levy directly.

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.

(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?

The Association reiterates our previous comments, that if Cost Recovery is to be applied, it should be applied fairly to all parties who have generated the need for the supervisory activity, and that there should not be an unequal playing field between markets and between different participants.

For these reasons, if Cost Recovery is to be pursued at all, then relevant costs fairly attributable to the ASX 24 market should be recovered from that market.

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.

The Association has previously argued that an amount equal to any pecuniary penalties issued by the Market Disciplinary Panel (MDP) should be directed back to the industry and not simply retained by Consolidated Revenue.

This would reflect the previous situation, where fines raised by the ASX Disciplinary Tribunal were directed to industry development purposes including the enhancement of market integrity. In the same way that the ASX did not seek to be a beneficiary from pecuniary penalties for misconduct, the Association believes that the Government should not be seen to profit from the level of penalties raised.

Whilst there may be statutory requirement for penalties to be paid to Consolidated Revenue, the Government could make a commitment to make a payment of an equivalent amount towards the costs of ASIC Market Supervision and/or a fund to support projects which serve to increase regulatory compliance and education, both of which should reduce future non-compliance within the industry and enhance investor protection.

It would not be improper for ASIC's Market Supervision Costs to receive partial funding from such grants. To the extent that this would reduce the overall amount sought to be recovered from Market Operators and Market Participants, this would reward Markets and Participants with a clean compliance record, and act as a financial incentive to ensure compliance and to avoid regulatory breaches.

Sanctions for non-payment 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.

(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?

(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?

Our Members do not have any strong views on the proposed tiered approach for late payment fees.

As regards the proposal for defined powers to be granted to ASIC in relation to non-payment of cost recovery fees, our Members do not believe that such powers are needed.

We do not believe that the scenario where an entity would deliberately decline to pay the levy on an ongoing basis in the absence of financial hardship is likely to be a frequent one. If there was such hardship, suspending or revoking a licence would be fatal to the entity's chances of ever paying the outstanding or future levy amounts. Hence, it would be preferable for there to be a considered approach towards managing the late payment through periods of financial difficulty, rather than a draconian one.

We would have thought that ASIC would have ample powers already with respect to an entity's licence if the entity lacked the financial resources to meet its liabilities as they fell due, or if management was deliberately refusing to meet a statutory obligation. These powers could be used by ASIC in cases where this was appropriate. Determining which cases are appropriate should be a matter for judgment, and do not need to be overly prescribed in law or regulation.

Provision for repayment of over-recovered fees

(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?

The Stockbrokers Association reiterates its strong submission that there be sound and prudent budgetary processes that govern ASIC's Market Supervision costs. It would not be a desirable outcome if funds allocated in one year were spent unnecessarily to ensure that future allocations were not jeopardized if the funds remained unspent.

Similarly, it is also not desirable for the Government to over-recover through cost recovery.

Lastly, repayment of excess recovered fees raises all sorts of difficulties as to how to equitably return the over-payments. In particular, to what extent should resources be consumed in analyzing whether one or more particular types of trading, class of entity, or type of messaging, gave rise to the over-recovery? Should the over-recovery be distributed only to those areas, or to all entities liable for cost recovery? Would that result in some entities or sectors receiving a windfall return?

These issues reinforce our argument that the cost recovery fee levels should err on the side of under-recovery. The Association would support the introduction of suitable legislative changes that would enable any excess funds obtained through cost recovery in one year to be applied towards the subsequent one or more years to reduce the amount to be recovered in those years. Attempting to determine in an equitable way how to return over-recovered amounts would, for the above reasons, present significant practical challenges.

CONCLUSION

In summary, the Association strongly submits that many of the policy dilemmas that are now being sought to be resolved in the Questions in the Options Paper are indicative of the adverse impact that cost recovery is having on the functioning of Australia's equities markets, and the difficulties inherent in resolving these issues in a fair way consistent with usual cost recovery principles.

Given the utmost importance of the equities market to Australia's economy overall, this should dictate that cost recovery not be pursued in this important industry, consistent with the many other important industries where cost recovery is also not pursued.

We would be happy to discuss any issues arising from our submissions on this issue. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3200 or email pstepek@stockbrokers.org.au .

Yours sincerely,

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