



Proposed financial market supervision cost recovery model

ASX submission

23 September 2011

ASX supports the proposed framework

ASX notes the Government's decision to extend the cost recovery mechanisms for certain ASIC functions to the exercise of new powers and responsibilities. These new functions result from the transfer of some market supervision functions from ASX to ASIC and the conferral of new powers to exercise market supervision responsibilities in an environment which is altered by the introduction of competition for equity trading. It is important that these functions are adequately resourced.

In the context of the Government's decision to adopt a cost recovery approach, ASX supports the broad framework of the cost recovery model put forward. The model is premised on a user-pays system, where those who engage in the activity being supervised are charged for it.

ASX does not support the alternative models put forward because they do not reflect a user-pays system to the same extent as the proposed model.¹ ASX supports the proposed approach of charging proportionally in arrears, which appropriately avoids the over- or under- payment that could arise under the fixed fee per trade / message count alternative proposal.

ASX supports a strong framework for transparency and accountability

It is important that the cost recovery process is very transparent as to:

- what costs are being recovered²
- method of calculating the charge³
- accountability mechanisms (see comments below)
- method for adjustments or changes going forward (see comments below).

ASX supports the key principles and industry considerations set out in table 2.2 on page 9. However, we also recommend the adoption of two additional principles: efficiency and accountability.

Efficiency: ASIC should seek to achieve productivity gains and these should be used to improve the efficiency and effectiveness of the market supervision functions and to reduce the unit cost of providing these functions over time.

Accountability: Any cost increases (net of productivity gains) should be limited to no more than CPI and should be disclosed to the market in the context of a Cost Recovery Impact Statement (CRIS) that is subject to stakeholder feedback.

These principles, in conjunction with a CRIS consultation process, will provide market users with an enhanced ability to ensure that the cost recovery process continues to reflect the Government's cost recovery principles over time, and that increases to ASIC's costs are not disproportionate to the benefits that flow from ASIC's activities.

¹ The alternatives set out at page 14 of the consultation paper are a proportional fee based on trade count only, and a fixed fee per trade and /or message count.

² According to tables 4.2 and 4.3 of the consultation paper these relate to the following: market supervision; participant supervision; regulatory framework; investigations and enforcement; market disciplinary panel; surveillance IT; ASIC shared services costs.

³ According to part 5 of the consultation paper the method involves a two-stage allocation: 1. between market operators and market participants based on what activities the costs are supporting and for certain shared costs on revenue; 2. between members of those two groups based on trade count and message count.

ASX supports a three-yearly review of the framework

The Government's intention to review the fee model and cost recovery arrangements is appropriate. However, the proposed 18-month framework is too short a time period for meaningful conclusions to be drawn, for industry structure to take shape in the new environment, and for market users to plan ahead with certainty. ASX recommends that the review occur not less than three years after commencement, and that the review focus on assessing whether the revenue proportions remain current, and whether the mix of trade count and message count is the right mix to reflect ASIC's cost drivers.

Without viewing the draft regulations, it is difficult to comment on how the framework is likely to operate in practice and, in particular, how successfully it will accommodate change and evolution. We submit that the regulations should provide for a predictable and consistent method of cost recovery which can be applied to ongoing developments, including ASIC enhancements, new market operator order types or products, extension of existing trading hours, new participant crossing engines, etc. The alternative to establishing a framework that can anticipate and accommodate such developments is, presumably, an ongoing process of drafting new regulations and accompanying CRISs which will detract from certainty and add complexity and costs to the model.

Allocation methods

ASX supports the proposed allocation of costs between operators and participants. We agree that costs borne as a direct result of participant oversight should be recovered from market participants only. We agree that there are certain costs which arise from the activities of participants and market operators which should be recovered from both groups. We support the proposed mechanism for allocating shared costs across the two groups (based on revenue) and within each of the groups (based on trades and messages).

The cost recovery equation does not take into account fines revenue received by ASIC through the disciplinary tribunal. We strongly urge ASIC and Government to put in place arrangements so that fines revenue can off-set supervision costs before they are levied on participants and market operators as this revenue is a direct consequence of some of the activities undertaken by ASIC in administering Part 7.2A of the Corporations Act.

ASX supports the proposed revenue method for allocating costs between operators and participants

ASX agrees that the proposed revenue method for allocating costs is fair and transparent and will result in an equitable distribution of costs. We recognise the challenge in determining what revenue lines should be included in this calculation in order to achieve an equitable outcome for participants and market operators. It is important that there are clearly articulated principles and a transparent method for making the revenue calculation. We have commented below where we feel that the proposed application of the revenue method may not deliver an equitable outcome.

The analysis in the Consultation paper is based on calendar year 2010 revenues. The significant ASX trading fee reductions referred to elsewhere in the consultation paper were introduced in mid-2010. Consequently, using 2010 revenue has the effect of inflating ASX's trading revenues. Under the proposal, the regulations would fix the proportion for 18 months (or, as we recommend, three years). The revenue calculation should be based on current information (i.e. financial year 2011 revenues) to remove this bias. Ideally, the regulation would also include the ability to re-calculate the

revenue proportion annually by the same formula. This would mean that subsequent changes in revenue are factored into the model without the need for a new regulation or a review every 18 months.

In respect of ASX's revenue, we do not object to the proposed inclusion of cash equity trading, some connectivity and some information services revenue. However, ASX will provide information to assist Treasury and ASIC determine the exact proportion of connectivity and information services revenue that is attributable to ASX (as distinct from ASX 24) revenues.

We note that there is no clear policy or other ASIC cost-driver basis for including cash equity clearing and settlement revenues. There is no direct nexus between market operator or participant activities that earn clearing and settlement related revenues and ASIC's cash equity market supervision functions.

ASX's clearing and settlement activities are carried out under a separate CS facility licence and ASX continues to have a legislative obligation to supervise these facilities. This obligation was not transferred to ASIC in August 2010. We assume that the likely rationale for including both clearing and settlement revenue is that participant brokerage is typically a bundled service, and estimating the proportion which should be excluded attributable to provision of clearing and settlement services not supervised by ASIC may require some additional work. ASX does not regard avoiding the need to apply such a discount as being consistent with the principles underpinning the cost recovery framework.

The inclusion of ASX's listings revenue is even more inappropriate. If retained, it would give rise to a very significant misallocation of costs to be recovered as between market operators and market participants. It would undermine any suggestion that the overall outcome was based on those who are supervised being charged for it. There is a tenuous connection between this revenue and the costs associated with competition and market supervision. An important difference is that ASX bears the ongoing costs associated with undertaking whole-of-market monitoring for breaches of the listing rules, including real-time supervision associated with continuous disclosure monitoring. The supervisory arrangements for listed entities have not changed. The most directly comparable revenue source for Participants is derived from their equity capital market and investment banking activities. Our understanding is that these revenue sources will not be included in the model for participants. The inclusion of ASX listings revenue will, therefore, unfairly discriminate against ASX (and by association other market operators included in this revenue pool).

We query whether the proposed 50:50 split for costs relating to the implementation of market competition is appropriate. The cost recovery model is intended to fund specific powers and functions vested in ASIC, as reflected in Part 7.2A of the Corporations Act. To the extent that ASIC has facilitated the Government's competition agenda, it has been through the exercise of ASIC's rule making powers under this section of the Act. There does not appear to be any rationale for using a 50:50 proxy for determining the driver of these costs, rather than the revenue apportionment method being used for ongoing rule making and other costs.

We also note that ASX and Chi-X will be required to pay an additional amount to cover ASIC's surveillance set-up costs for PureMatch and Chi-X respectively. We do not object to the cost recovery principles being applied in this way subject to our comments on efficiency and accountability made above.

ASX supports the proposed allocation of costs between market operators

We agree that the proposed method of cost recovery from market operators is fair, consistent with Government policy, and will not unduly stifle competition or industry innovation.

The use of a mix of trades and messages to apportion costs between market operators is an appropriate compromise, consistent with the direction of international regulators, and appears designed to target ASIC's cost drivers. As noted above, we agree that trades and messages represent a fair and reasonable proxy for ASIC's cost drivers.

ASX would strongly object to any alternative formulation which deviated from the cost recovery principle. For example, ASX would strongly object to the use of revenue as a means of allocating costs between market operators. The outcome of such an approach would be cross-subsidisation or wealth redistribution within the group. The larger entity would be unjustifiably penalised for having achieved more market share in a competitive environment.

ASX supports immediate application of the proposed model to futures markets supervision

The proposed cost recovery model is only to apply to cash equities. The Government proposes to consider arrangements for the oversight of futures markets (i.e. ASX24) in 18 months. We see no reason why the proposed model should not also provide a simple and equitable solution for cost recovery in relation to futures supervision.⁴ ASX would support the extension of the proposed model to ASX 24 to coincide with the 1 January 2012 commencement date.

There is no strong reason for not proceeding now. Having separate starting dates would reinforce current misconceptions that the extension of cost recovery to costs incurred by ASIC in exercising its new powers under Part 7.2A of the Corporations Act is exclusively about recovering costs associated with exercising those new powers in a multi-operator market. On the contrary, these new powers have also been exercised by ASIC in relation to supervision of market participants in the ASX 24 market and other financial product markets from the same date that ASIC commenced supervising market participants in the equity market.

Estimating the benefits of competition

ASX is unsure why the section “Estimating the benefits of competition” has been included. The analysis is not relevant to the merits or structure of the proposed cost recovery model. The appropriate time for a cost-benefit analysis of equity market competition would have been several years ago before the Government adopted a policy of promoting competition. Some specific shortcomings with this section are highlighted below:

- There is no recognition of tangible upfront costs of competition beyond ASIC’s increased costs. Any cost-benefit analysis should also take into account the costs associated with the introduction of competition and borne by participants, vendors, and market operators, such as the well-documented increases in technology costs.
- A key assumption underpinning this section is that benefits of competition will arise in part from, “narrowing of bid-ask spreads, as a result of increased turnover and depth of book at appropriate prices”. While the hope that narrower bid-ask spreads in conjunction with improved depth will result from increasing the number of venues has driven the competition agenda, we are aware of no studies anywhere from which it could be extrapolated that there will be a reduction of sufficient magnitude to offset the estimated increase in costs of intermediation associated with cost recovery.
- The section claims “Competition (or the threat of it) may have already had some preliminary impact on reducing bid-ask spreads”. Spreads are a product of a number of factors, including the proportion of trades conducted off-market in dark pools. While it is possible that spreads may reduce further if more high frequency traders are attracted to the Australian market, it is also possible that spreads may increase as a result of the increasing number of dark pools operating in Australia and new off-market crossing rules which take effect from 31 October 2011.

⁴ Some tailoring of the methodology could be considered, for example using the number of contracts traded in place of the number of trades executed.

- The section claims that issuers and investors will receive large and positive net benefits from competition. These claims appear to be without foundation and do not take into account research from the US and Europe which suggests that issuers and investors have seen little benefits from competition⁵. The Stockbrokers Association of Australia (SAA) submission to the recent Parliamentary Inquiry into the Corporations (Fees) Amendment Bill also stated, “The reality is that the client is unlikely to see any significant benefits of the move to multiple stock markets”. Finally, we note that any increase in manipulative trading or insider trading could adversely impact issuers and investors.
- The section claims that participants will receive large and positive net benefits from competition “as monopoly exchange fees have been historically high”. As with the statements above, there is no evidence presented to justify this claim in respect of ASX fees. Indeed, testimony by the SAA to a Parliamentary Inquiry on Monday 12 September was that brokers are not benefiting from competition.

⁵ *Market structure is causing the IPO crisis* (David Weild and Edward Kim, Grant Thornton LLP, October 2009); *A wake-up call for America: A study of systematic failure in the U.S. stock markets and suggested solutions to drive economic growth* (Weild and Kim, Grant Thornton LLP, November 2009).