Proposed Industry Funding Model for the Australian Securities and Investments Commission

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ASX

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General comments

Thank you for the opportunity to provide comments on the revised industry funding model for ASIC.

ASX recognises that a broadly-based industry funding model can play a role in supplementing Government budget funding of the important regulatory activities undertaken by ASIC. It can contribute to the Government's Budget repair objectives while ensuring the regulator has sufficient resources to perform its activities.

The decision to recover 100 per cent of ASIC's Budget through annual levies and fee for service charges, an additional $190 million a year, will potentially have significant effects on the structure and operation of financial markets because of the financial impact on different activities.

The cost burden being placed on industry to fund ASIC's surveillance, investigation and enforcement activities should be reduced by ensuring fines and other penalties flowing from them are channelled back to the regulator and not into Consolidated Revenue.

The governance framework around industry funding does not provide rigorous controls over: the overall level of ASIC's funding; appropriate incentives for ASIC to deliver operational efficiencies; or to prioritise regulatory resources towards the most high-risk activities.

While the Government retains control of ASIC's annual budget allocation, and hence the total amount to be funded by industry, there appears to be limited incentive to restrain ASIC's costs or drive efficiencies. Industry would have more confidence in that process if the Government retained funding 'skin in the game' by continuing to partially fund ASIC's operations.

There remains a strong case that ASIC's general overheads (accommodation, human resources and finance functions) as well as its policy advice functions should be budget funded as core Government activities.

In providing comments on the revised funding model it has not been possible for industry to consider both elements of the full model (annual levies and the fee-for-service arrangements) as part of one integrated package as was done back in August 2015. The consultation paper notes that the Government will be consulting next year on the details of revised fee-for-service arrangements. These charges are expected to recoup around 12% of ASIC's overall costs. Without any detail on those charges (e.g. how they are distributed across regulated sectors) it is difficult to assess the overall impact of industry funding on different entities and activities and whether the right balance has been struck between the two elements of the model.

The existing ASIC Market Supervision Levy has provided a good case study of a model based around detailed transparency into how costs are allocated between market infrastructure providers and participants.

To date, there is not equivalent degree of transparency in relation to the methodology underpinning some of the variable levy calculations. While the broad drivers have been identified, more granular detail on the parameters would make it possible for all stakeholders to assess the overall impact and fairness of the new arrangements.

We acknowledge that this detailed information may become clearer in October 2017 when regulated entities will be advised of indicative fees that they would have faced if the new arrangements had been in place to fund ASIC's FY17 Budget.

Rewarding good behaviour

Designing a funding framework based on a detailed risk-weighting of regulated entities and activities would be burdensome and complex given the wide range of activities and entities ASIC supervises. However, it would incentivise good corporate behaviour if some element of the new arrangements could, in some way, recognise those entities that devote significant resources to meeting their licence and other regulatory obligations.

Under the new framework, it is anomalous that industry will be funding all of ASIC's surveillance, investigation and enforcement activities but is not able to benefit from any funds that are recovered through fines or other financial penalties. In FY16 ASIC collected around $108 million[1] in fines across all of its operations and the Government is currently reviewing the adequacy of penalties for serious contraventions that may see this increase in the future. However, these funds flow directly to Consolidated Revenue rather than being made available to offset industry funding obligations.

Given annual ASIC levies will be based on funding the actual regulatory costs expended in the preceding financial year it would be possible to design an arrangement that would allow fines and penalties collected in the previous year to be hypothecated back (in full or part) to offset annual levies to be collected from that sector. While the ideal situation would see the fines used to offset only those levies paid by fully compliant entities that may prove to too complex to implement in practice.

Where ASIC imposes conditions or other remedial actions on entities that have breached their regulatory obligations, and which will involve ongoing ASIC monitoring, these costs should be recovered directly from the individual firm and not spread across all regulated entities.

Maintaining the competitiveness of Australia's regulated sector

Some of the changes made to the industry funding model since the initial consultation has provided some relief, particularly for smaller regulated entities, that may help to remove any barriers to entry for new businesses, facilitating greater competition and innovation.

[1] Source: ASIC Annual Report 2015-16, page 138

However, concerns remain that the impact of the new levies may be to drive activity away from well-regulated domestic products and activities into less regulated and/or offshore-based alternatives.

Listed companies, financial market infrastructure providers and intermediaries already bear significant compliance costs to meet their existing regulatory obligations. Additional financial disincentives may encourage some entities to remain (or move) outside of the regulated sector.

This would appear to be inconsistent with one of ASIC's legislated objectives to 'promote confident and informed participation by investors and consumers in the financial system'. The general public policy objective should be to motivate participants, where possible, to become part of the regulated sector and ensure retail consumers are protected by the highest regulatory standards. It is no coincidence that many of the most prominent financial failures and scandals have emerged from the less regulated parts of the financial sector.

For example, the growth of a significant shadow broking sector which operates without some of the client protections associated with dealing with participants of licensed markets has raised concerns about regulatory oversight of this area. It does not seem to be in the best interest of consumers to introduce further incentives that could make it even more attractive for entities to move into less regulated activities, particularly when it may be difficult for consumers to identify which category their service provider falls into.

It is also important that Australia remains an attractive place to operate financial services businesses. This includes attracting foreign financial firms to participate in our markets and foreign companies to choose Australia as a listing venue. While a range of factors will drive these decisions, and some activities will be more sensitive to price signals, the nature and cost of regulatory arrangements will play a significant role.

The Government should benchmark the costs of regulation in Australia against major global competitors on a regular basis to ensure Australia remains an internationally competitive financial services sector.

Comments on specific industry funding methodologies

Corporations

ASX notes the substantial new fees to be charged to Corporations, particularly listed entities.

Companies already contribute significant revenue to government through payment of corporate taxes. The new levy, based on an entity's market capitalisation, appears to be only marginally connected to the regulatory effort ASIC actually applies to these individual corporations. It appears more like a simple tax, albeit one that is based on a company's value rather than its income.

It seems anomalous that a company may be 'penalised' through a larger regulatory levy (at least up to the capped amount) just because its share price increased or may be 'rewarded' in response to a lower share price.

While we understand the desire to keep the methodology simple, if the levy is more like a tax than a user charge then it makes sense to apply simple tax policy principles to minimise distortions to economic activity. For example, applying a relatively low rate to a broad base rather than the alternative of applying a relatively high rate to a narrow base.

The model to fund ASIC's regulation of corporations uses both approaches.

For the 2.1 million small proprietary companies there is a nominal $5 annual levy per company that generates just under $10m per annum in revenue while having negligible impact on the operations of those entities. Even a doubling in that annual levy would be expected to have a minimal impact on activity while providing scope to trim the fees of some other groups.

In contrast, 2,200 listed companies will contribute a total of $48m a year. Individual companies will pay between $4,000 a year for small companies (valued at less than $5m) and $660,000 for large companies (valued at more than $20bn). This differential is substantial and implies that the regulatory effort applied to large companies is 165 times that for smaller companies. For some companies, the new charge could affect a new company's decision on whether to list or whether to choose Australia as its listing destination.

The proposed levies also appear to be significantly higher than in other markets such as the UK. For example a $1bn company would pay around $27,000 a year in Australia compared to $16,000 (at current exchange rates) in the UK, while a $20bn company would pay $660,000 compared to $65,000. In an increasingly globalised capital market, Australia needs to compete to attract quality listed companies to enhance our global reputation as a good place to raise capital while also offering attractive investment opportunities for investors.

Listed companies will also be subject to fee for service charges for activities that ASIC supervises such as capital raisings and corporate transactions. In the absence of detail of how those user fees are structured it is not possible to assess if the appropriate balance between annual levies and user fees has been found and whether they reflect the resources applied to different aspects of ASIC's regulatory activities.

ASX recognises that under the way the model is designed, if the overall funding to be collected from companies is unchanged any redesign of the methodology will only shift costs from one company to another.

For example, the consultation paper asks whether foreign companies and stapled securities listed on a domestic exchange should be subject to the same levy arrangements as other listed entities. In the absence of any insight into the regulatory oversight ASIC provides to these entities it is difficult to determine if removing or reducing the levy would produce an equitable outcome. It is worth noting, however, that such entities comprise around 15% of the total market capitalisation of the Australian market and any lessening of the burden on these companies would involve a commensurate increase on other listed entities.

As noted above, one method to reduce the overall cost burden on Corporations would be to recycle any fines and penalties paid by entities, such listed companies, for breaches of the Corporations Act back to ASIC.

Market infrastructure and intermediaries

The underlying approach to industry funding does not appropriately recognise that financial market infrastructure providers and market participants already commit significant private resources to comply with their license and disclosure obligations.

The additional regulatory costs associated with industry funding will not encourage more activity through regulated markets relative to the less regulated alternatives. Reducing the overall cost burden through the hypothecation of fines collected by ASIC for breaches of the Market Integrity Rules or other regulatory obligations could help ameliorate this new impost.

In relation to the design of the levy, using a similar methodology to the existing ASIC Market Supervision Levy to allocate overall costs between market infrastructure providers and intermediaries makes sense. Those arrangements have worked well and ASX supports the continued use of both trades and messages as the metrics to allocate costs amongst infrastructure providers and intermediaries.

A strength of the existing approach is the high degree of transparency into how costs are allocated between regulated entities. That same level of transparency is not currently available in relation to the parameters that underpin some of the variable levy calculations in the new model. More detail would make it easier for all stakeholders to assess the impact on themselves, the overall fairness of the new arrangements, and on the operation of markets.

The ASIC Supervision Levy model not only collects revenue in a relatively fair manner but has also delivered good market outcomes. For example, imposing an appropriate charge on order messages ensured that certain active trading strategies based on a high order/trade ratio are required to pay a fair share of the regulatory costs alongside more traditional long-term investors.

It is important in the interests of fairness and market quality that a reasonable balance between trade and message based fees is maintained. The existing arrangements also recognise the important role that market makers can play in facilitating liquidity to support particular complex or illiquid securities.

While the order to trade ratio in the Australian equity market rose following the entry of an alternate market trading platform for ASX-listed securities, the introduction of the ASIC levy halted that upward trend and has ensured the ratio declined and then remained relatively stable over recent years, and well below excessive levels in other overseas markets.

The proliferation of orders can fragment larger trades, with a single order to trade a parcel of securities interacting with multiple orders on the other side to generate a number of trades. This fragmentation can reduce the quality of execution for larger blocks of shares, increasing both transaction costs and execution risks for investors while also providing greater incentives for off-market trading. The number of trades has risen sharply from 567,000 a day in FY11 to 931,000 in FY16. At the same time the average trade size has almost halved.

A proliferation of, particularly small fleeting, messages can also directly increase ASIC's data collection costs and complicate market surveillance. The excess noise can add complexity to the identification and investigation of suspicious trading activity, and the enforcement of breaches of the Market Integrity Rules.

Ensuring the right balance is maintained between trade and message-based fees will ensure there is no incentive towards trading strategies built on excessive order/trade ratios in Australia and that overall market quality is preserved.

The new funding framework also involves futures market participants being directly levied by ASIC to cover costs of their regulation for the first time. This charge appears to be modelled on similar arrangements for equity market participants, i.e. a fixed fee on each participant plus a variable fee based on the participant's share of trades and messages.

The impact of the new levy on trading activity in exchange-traded futures relative to their OTC equivalents is difficult to determine without a deeper understanding of the precise definition of trades and messages to be used and the total amount to be collected from this group of entities. This would enhance transparency for all participants on the distribution of the levy and provide confidence that this is being done fairly.

Understanding the impact the new levy may have on the operation of the futures market is critical if it is not to adversely affect the important risk management/hedging function this market performs.

- The detailed design of the levy should be calibrated to appropriately reflect any differences in the operation of the equities and futures market. For example, the role that market makers play in providing liquidity in forward contract periods.

- The users of the futures market would likely be concerned if the levy acted to inhibit important trading activity concentrated in the lead-up to the monthly contract roll period. Such an outcome could have the effect of reducing the efficiency of that process.

- There is also the potential for the additional costs to reduce participation in the futures market, which is more global by nature than the equity market. There are a number of trading participants which are located offshore and trading in interest rate and equity futures is also conducted outside of normal Australian business hours. This activity may be particularly sensitive to regulatory price changes given that these traders are largely agnostic on the location of their trading (i.e. they can easily substitute into other products and markets). Such an outcome would reduce liquidity in the Australian market.