



30 September 2011

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Financial Markets Unit  
Corporations and Capital Markets Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

By email: [MarketSupervision@treasury.gov.au](mailto:MarketSupervision@treasury.gov.au)

Dear Mr White

### **Market Supervision Cost Recovery Consultation**

The Australian Financial Markets Association (AFMA) welcomes the opportunity to comment on the Government's Consultation Paper on the 'Proposed financial market supervision cost recovery model' (Consultation Paper).

The AFMA is the leading industry association promoting efficiency, integrity and professionalism in Australia's financial markets and provides leadership in advancing the interests of all market participants. These markets are an integral feature of the economy and perform the vital function of facilitating the efficient use of capital and management of risk. Market participants perform a range of important roles within these markets, including financial intermediation and market making.

AFMA's comments on the Consultation Paper are set out in the attached paper.

AFMA members recognise that cost recovery is a government policy and are willing to pay their fair share of the costs of ASIC market supervision, commensurate with the need to maintain a fair and efficient market. The Government's underlying policy decision on cost recovery is fundamentally flawed because it ignores existing excess ASIC related cost recovery measures and other contributions to revenue made by and through the financial services sector.

The proposal in the Consultation Paper:

- asks market participants to pay more than their fair share;

We are concerned that the proposal in the Consultation Paper asks market participants to pay more than their fair share, makes incorrect allocations, underestimates the adverse impact on the industry and investors, and overestimates the initial benefits of competition. The Government needs a cohesive and consistent policy for cost recovery oversight and governance, which would allow the overall micro-economic impact of charges across the economy and particular sectors to be assessed and taken into account. The international Standard Cost Model regulatory burden estimate already amounts to around \$1.33 billion on the financial services sector per annum.

The Government raises excess revenue through ASIC administered revenue measures that amounted to \$204 million in 2009-10. This excess revenue amount is continuing to increase and provides more than ample coverage for financial market supervision costs.

Despite our disagreement about the need for the proposed cost recovery measure and its fundamental fairness, we provide, within the confines of the framework given in the Consultation Paper, revised cost allocations which go some way to addressing the fairness and equity of the proposal. In this context, \$8.78 million is fair recoverable amount for the period 1 January 2012 to 30 June 2013.

AFMA appreciates the opportunity to comment on the Government's Consultation Paper. Please do not hesitate to contact me at [dlove@afma.com.au](mailto:dlove@afma.com.au) or (02) 9776 7995 for further clarification or elaboration as required.

Yours sincerely

A handwritten signature in blue ink that reads "David Love". The signature is written in a cursive, flowing style.

**David Love**  
**Director, Policy & International Affairs**



**MARKET SUPERVISION**

**COST RECOVERY CONSULTATION**

**30 September 2011**

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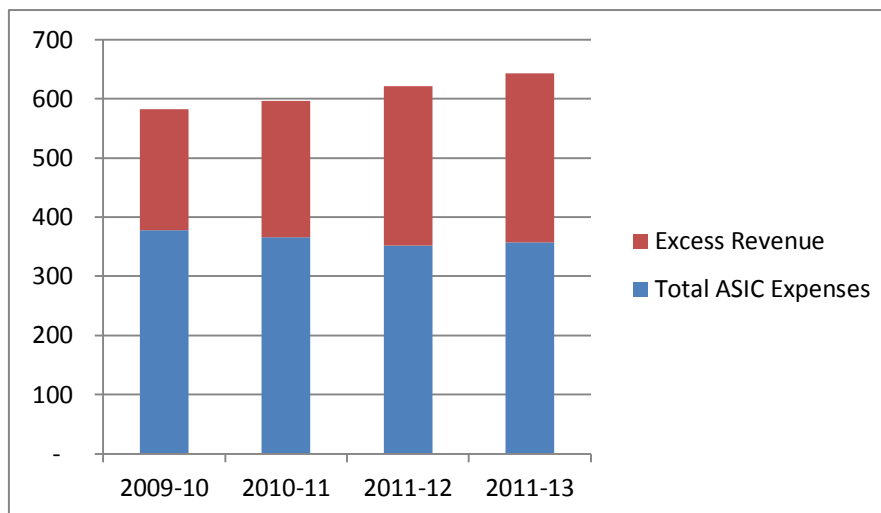
## 1. POLICY ISSUES

### 1.1. Supervision Costs are Presently Recovered to Excess

There is an incorrect underlying assumption to the Consultation Paper and the Government's policy decision that there is no existing cost recovery by government that addresses the costs of market supervision. The proposed cost recovery, in addition to the existing costs recovered, will result in surplus cost recovery. Consequently, AFMA considers the proposed in the Consultation Paper to be an ill-conceived policy arrangement and detrimental to national productivity.

In FY 2009-10, non-taxation revenue in the form of fees and penalties collected by ASIC amounted to \$582 million. For the same period, ASIC's total expenses were \$378 million. After taking into account ASIC's total expenses, revenue collected by the Commission made a positive contribution of \$204 million to government income. **Chart 1** below draws on government budget estimates to illustrate how the Government is reallocating expenses to increase the revenue received through fees and penalties collected by ASIC to benefit its income. This huge excess cost recovery is not recognised, analysed or explained anywhere in the Government's underlying policy decision or in the Consultation Paper. This is a fundamental flaw in the presentation of the Government's proposals and a failure to address it in the cost recovery impact statement (CRIS) will diminish the validity of the consultation process and the justification of the policy decision.

**Chart 1 Excess revenue from ASIC administered revenue collections - \$ million**



### 1.2. Conflicted Revenue

The ASIC revenue arrangements create the incentives for government to use such cost recovery measures as a revenue raising tool. There is no incentive for the Government

to limit revenue increases because it has a basic conflict of interest. In contrast, the APRA levy does not raise excess income for the Government so does not create a conflict of interest to the same degree. One way to deal with the Government's conflicted revenue arrangements, such as would be the case if it had some 'skin-in-the-game', is through allocation arrangements to ensure that it suffers a penalty commensurate with that of the community if it does not effectively control regulatory cost increases.

There are other contributors to government revenue that are not being taken into account when the Government consults on cost recovery measures. To illustrate this point the following table is drawn from data AFMA provided earlier this year to the Senate Standing Committee on Legal and Constitutional Affairs inquiry into the Australian Transaction Reports and Analysis Centre Supervisory Cost Recovery Levy Bill 2011. **Table 1** demonstrates how the large positive contribution made by financial services institutions in assisting the government to combatting money laundering goes unrecognised when there is consultation on agency cost recovery. AUSTRAC supervision is a huge regulatory burden on the financial services sector and which does not provide any commensurate benefit to it.

**Table 1 Industry contribution to government revenue – AML/CTF regime**

<b>Benefit to government revenue</b>	<b>\$ million</b>
Tax revenue recovery by ATO	302
Australian Government agencies <sup>1</sup>	11
Australian social justice agencies	7
AUSTRAC levy	29
<b>Annual gain to government revenue</b>	<b>349</b>

### 1.3. Policy Analysis Problems

Beyond the non-recognition of the existing contribution made by market participants and other financial services players to the costs of supervision, the Consultation Paper fails to recognise the wider contributions made to government revenue and the economy by the financial services sector and applies an overly narrow analysis based on transaction cost impacts. For example, Table 7.3 does not acknowledge that the Government is a stakeholder that could enjoy greater revenue from a more efficient market resulting from greater investor income and higher profits.

Australia's financial markets are successful and are a key component of the health of our economy, in part due to their carefully considered design that has evolved over 150 years.

<sup>1</sup> Annualised proceeds of crimes collection by the Commonwealth: Transnational crime brief no. 1 Canberra: Australian Institute of Criminology, January 2008

Financial services is the fourth largest sector in Australia's economy, generating 8.1 per cent or \$81 billion of real gross value added in 2008-09<sup>2</sup>. The financial services industry contributes to economic growth and in turn increased tax revenue in other sectors such as communications, property and business services. The financial services industry makes around a 9 per cent contribution to GDP and provided 27.6 per cent to company tax receipts in 2008-9. In addition, a significant proportion of income tax revenue is made from dividend income that flows from investment of Australian individuals either directly through the share market or indirectly through managed funds.

Beyond concerns about the appropriateness of cost recovery where excess revenue is already being raised, there should be a clear delineation between the policy objective of finding a fair and appropriate basis for cost allocation and other policy concerns that should be addressed separately.

#### **1.4. Recognition of the Cumulative Burden of Regulation**

A CRIS also needs to take into account the broader burden of regulation. There is a lack of official Australian data on the burden of regulation imposed by government. One method that can be applied is to use the International Standard Cost Model (SCM). Based on the analysis by the Victorian Government<sup>3</sup> some initial estimates can be proposed. It is conservatively estimated that the SCM for Australia can be quantified at 1 per cent of GDP. Based on Australia's 2010 GDP of \$1.448 trillion the SCM for Australia as whole would be \$14.48 billion. The financial services sector represents 9 per cent of GDP. This means that the regulatory burden under the SCM amounts to around \$1.33 billion for the financial services sector per annum. This is a very conservative estimate as the sector is recognised internationally to be highly regulated and in comparison to other sectors of the Australian economy. Even this low figure represents a sizeable drag on the industry's contribution to the economy.

AFMA is seriously concerned with the overall ad hoc nature of the cost recovery process across the financial system and the cumulative effect that a multiplicity of new regulation is having on the efficiency of Australia's financial markets. New government regulation and charges that increase friction in conducting financial transactions affect how business views the competitive environment and the relative attractiveness of doing business in Australia compared to other jurisdictions. We believe that the government process for establishing and reviewing recoverable costs should fit within a coordinated economic policy framework that takes into account the economy-wide impact of multiple service charges. Cost recovery measures should be subject to

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<sup>2</sup> Source: Australian Bureau of Statistics - Time Series Workbook (released 2 September 2009)

<sup>3</sup> Source for analysis of SCM: Estimate of Victoria's Administrative Burden - A DTF internal working paper August 2007

effective governance and accountability arrangements to ensure that administrative costs are reasonable and contained over the long term.

New government costs and charges are an impost on business that will affect how the competitive environment and the relative attractiveness of doing business in Australia, compared to other jurisdictions, are viewed. Most charges associated with government activities, particularly those related to regulatory activities, are paid by firms rather than individuals. To the extent that they are then passed on to counterparties (including consumers), increased prices or a reduction in the range of products or services available will result.

The industry recognises that, when viewed in isolation, most regulation is reasonable; however the cumulative effect of all regulatory measures builds into a burden which exerts a drag on the economy. As a wide array of new rules are implemented – both here and internationally – it is critically important for our economic growth, investor returns, and the global competitiveness of the Australian financial services industry that the cumulative weight of new rules and measures, such as cost recovery, is understood. The aggregate burden of such measures is not readily apparent, as government does not have a coherent mechanism for monitoring and reporting on the totality of measures from a regulatory burden perspective.

The current activity-by-activity approach makes the cumulative impact of regulation difficult for the public and policy makers to measure when working within the confines of their own portfolio responsibilities. For example, the recent development of the AUSTRAC levy and the personal property securities register fee arrangements will impose significant additional costs on the financial services industry. These measures have been developed in isolation and their respective Cost Recovery Impact Statements ignore existing non-taxation revenue fees and levies already paid by the industry. There is also considerable variability in the quality of analysis contained in such CRIS. For example, the APRA levy has a much sounder basis and rationale than does the AUSTRAC levy which is very uneven and uneconomic in its application.

Attention also needs to be paid to the general policy concern that, without effective checks and balances in the design of the system, the ability to cost recover can make it easier for agencies to justify inefficient practices, because by virtue of making no net call on the budget they do not face the same level of official scrutiny. The ability to raise revenue that is deemed to be partly sheltered from budgetary and Parliamentary scrutiny because of dedicated sourcing and application for agencies reduces incentives to be cost effective.

### 1.5. Develop an Overall Statutory Framework

The Government needs a cohesive and consistent policy for cost recovery oversight and governance which goes beyond the current Guidelines in Finance Circular 2005/09. This would allow the overall micro-economic impact of charges across the economy and particular sectors to be assessed and taken into account. Instead of a piecemeal activity-by-activity approach to new cost recovery measures they should be developed by financial experts with appropriate modelling and quantitative skills to correctly measure inputs, outputs and costs and to provide an assessment of their impact on productivity.

The desire for consistency and general principles is in concert with the Government's overall approach to handling income from non-tax revenue measures. It is important to bear in mind too that a levy collected by agencies operating under the *Financial Management and Accountability Act 1997*, such as ASIC, APRA and AUSTRAC, flows directly into consolidated revenue. Agency funding is dependent on a budget appropriation which is at the Government's discretion and while it may be broadly correlated with the levy amount raised, the Government decides on the actual funding for each agency as part of the annual budget process.

Transparency and accountability are very important in ensuring that only the relevant supervision costs are funded through this process and also that any cross-subsidies are readily identifiable. The Productivity Commission (PC) in its 2001 report on cost recovery observed that:

*Accountability and transparency are very important for government agencies, particularly where cost recovery may be creating incentives for undesirable practices such as regulatory creep, gold plating and cost padding or... However, in the absence of a standard institutional framework for cost recovery, accountability and transparency have suffered. This lack of transparency is particularly significant where the ability to raise cost recovery revenue reduces the level of budgetary and Parliamentary scrutiny of an agency.<sup>4</sup>*

It described these undesirable incentive effects of cost recovery in the following way. Cost recovery can create incentives for undesirable activities, including:

- regulatory creep — where additional regulation is imposed without adequate scrutiny. Regulation impact processes may be followed less stringently when cost recovery is possible, and the burden of additional regulation may be underestimated when it imposes no net cost to the Government;
- gold plating — where unnecessarily high standards or facilities are adopted. The ability to cost recover may allow agencies to impose their preferred levels of

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<sup>4</sup> Productivity Commission, Inquiry Report – Cost Recovery by Government Agencies, Report No. 15 August 2001, p 181

service, rather than the minimum necessary to satisfy clients or achieve government objectives; and

- cost padding — where costs are artificially inflated, motivated by the knowledge that all costs can be recovered.<sup>5</sup>

### 1.6. Policy Principles

In determining its approach to allocation of IT costs to the market there are a number of principles that should inform the Government's approach:

- Allocation methodologies should not introduce incentives that detract from market efficiencies and good market practice.
- Extraneous policy objectives unrelated to fair cost apportionment should not be pursued. For example, allocation methodologies should not be used as *de facto* controls on activities, such as High Frequency Trading (HFT).
- Cost apportionment should not result in material changes to the market structure. Australia's financial markets have evolved over a long time and are internationally competitive. Market micro-structure changes can have direct impacts on the international competitiveness of Australian markets. In this regard there are established norms and practices in the Australian marketplace that regulators should consider when designing methodologies.
- Allocation methodologies should be designed such that they do not become front-of-mind for market participants – they should not be determinants of behaviour, but should be transparent as far as possible.
- Allocation methodologies should be neutral with respect to types of market participant.
- They should also be neutral to venue type such as lit and dark venues.
- Allocation methodologies should not ignore differences in potential risk to the market posed by different activities, nor should they rely on the fiction that IT processing costs are the same for all messages.
- Messages are not the primary driver of IT costs; the driver for IT costs is, as for all supervisory costs, ultimately the disorderly behaviour of a very few participants. The funding of these costs should be shared at least proportionally by those responsible (if not disproportionately) with the balance drawn from the beneficiaries of the market as a whole.
- The allocation methodology for charge allocation should be principles-based and not tied to the specifics of a particular version of market analytical software.

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<sup>5</sup> Op cit, p97 Box 5.1

- Methodologies should as far as possible avoid under or over charging.
- The methodologies should also try to conform to the industry considerations identified in the Consultation Paper.

The approach proposed in the Consultation Paper of a fixed fee per message for allocation of IT costs is not supported by AFMA as it does not conform well to these principles. We will consider each of these principles in relation to the proposed approach in further detail.

#### *1.6.1. Promoting Efficient Markets*

In a modern electronic market messages are the most fundamental building block. The great leaps in speed and efficiency of the electronic marketplace are built directly on large numbers of messages being able to move without inhibition to ensure that pricing and volume information is quickly and efficiently distributed and updated.

Australia's financial markets are open and competitive, and as a result they have attracted most major broking houses and many significant liquidity providers and market makers. These market participants compete in providing liquidity and tight pricing which results directly in more efficient markets. This greater efficiency is reflected in more accurate pricing of risk, better price discovery, lower transaction costs, and easier and lower cost capital-raising.

The proposed message charges would inhibit these practices as an incentive would be introduced to reduce the need to reprice. The logical response of these market participants will be to price their spreads wider within individual instruments, or to reduce the range of instruments where a market is offered, both resulting in an immediate and lasting hit to market efficiency. Many market makers work on very low margins and the potential impact of even modest charging changes should not be underestimated.

This effect has a temporal dimension as well. The most efficient market will have arbitrage pricing opportunities traded out as soon as possible. This implies frequent updates and frequent messaging – the more frequent the better for market efficiency.

Consider a multi-market arbitrage engine which for efficiency purposes should be present at all times just in case one of the markets gets out of alignment. This efficient activity may require thousands of orders, cancels and amends before a single trade, yet this activity is in the interests of the market as a whole and should be encouraged or at least not discouraged.

However, the messaging charge will, as in the individual instrument example, push against this and towards greater disconnects between instruments and lower efficiencies. It would lower competition in liquidity provision and stifle innovation.

### 1.6.2. *Market Structure*

Changes to charges to messages which are the key market microstructure element need to be very carefully considered as the consequences can be far reaching including impacting, or setting up a framework to impact, the international competitiveness of the Australian financial markets. The policy objective should be to have no discernible impact on the market's design or function when approaching the task of choosing fair and appropriate cost recovery methodologies.

The market itself has many long standing practices which it has evolved to enable efficient practices to flourish. This can be of assistance in designing methodologies. For brokers, this has long meant charging brokerage on a per traded value basis. Ultimately the benefit of a market is to those that execute trades – this is the value of the market to most participants and attaching fees to this activity has long been accepted by clients of broking firms. Orders in contrast, particularly passive orders at prices regularly updated to reflect prevailing conditions, are a benefit to the market rather than a cost. Participants accept paying for access to see these orders in the market. In some foreign jurisdictions, providers of these orders are even paid to do so by market operators.

### 1.6.3. *Irrelevant Policy Considerations*

Policy agendas unrelated to fair cost apportionment such as those relating to market structure should be subject to appropriate public consultation. We have particular concern with the comment in the Consultation Paper that:

*...recovering ASIC's IT costs based on the number of messages should encourage market participants to more carefully consider how they are consuming ASIC's IMSS capacity.*

This appears to create a *de facto* charge on activities such as HFT as a matter of conscious policy. It also bizarrely implies that market surveillance capacity of ASIC is somehow a relevant consideration for business to take into account when deciding to engage in financial transactions. Such a consideration is not relevant to the operation of an efficient market or appropriate to good policy relating to market integrity. It is noted that the policy consultation on this market structure issue is still to take place, that an ASIC consultation is expected in the near future, and that this would be the appropriate place for the consideration of such a proposal.

#### 1.6.4. Transaction Tax Characteristics

The proposal to calculate part of the levy on the basis of the number of trades and messages has the characteristics of a transaction tax. AFMA considers that the Government's tax review accurately identified the problems with a transaction tax:

*A tax that is levied on a good every time it changes hands is referred to as a transaction tax. The tax base for such taxes is determined not only by the value of the good but also the frequency of its transfer. In Australia, transaction taxes have generally been levied on a narrow set of goods and services and have a long history of use, probably reflecting their relative administrative simplicity.*

*Taxing on the basis of the frequency of transfer may discourage turnover of the good, such as housing, to minimise or avoid tax. Individuals and businesses may continue to use an existing good instead of a preferred alternative simply to avoid the tax. By reducing turnover, a high transaction tax can also make price discovery in a market more difficult. Reducing the certainty and quality of a price signal imposes additional risk on all those who engage in the market. The extent of these efficiency costs varies, and will be lower if the transaction tax is low relative to the benefit of undertaking the activity.*

*The narrow base of many transaction taxes and their interaction with other taxes can have an impact on resource allocation in the economy. For example, insurance products are subject to GST, insurance transaction taxes and, in some States, insurance companies can also be required to contribute directly to the funding of fire services. The interaction of these taxes increases the cost of premiums relative to other products, which may encourage people to take up less insurance than otherwise.*

*An additional efficiency cost arises where a taxable product is used as a business input, since the tax can encourage businesses to use a less efficient mix of inputs. In addition, such input taxes cascade through the production chain to affect the market price of the final product, reducing international competitiveness.*

*Transaction taxes also have equity implications as they tax only specific goods or activities. People may choose to engage in activities subject to higher rates of tax even though they have low incomes. Also, people with similar incomes may pay different amounts of tax because they turn over a taxed good more frequently. To address these equity issues, governments may narrow transaction tax bases to exempt certain types of people, such as some first home buyers for stamp duty on residential conveyancing. While of benefit to recipients, such exemptions add to the complexity of the tax system and increase the burden on the broader population.<sup>6</sup>*

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<sup>6</sup> Australian Government, Review - Architecture of Australia's tax and transfer system, Box 10.1: Transaction taxes, p293, 2010

Financial institutions and markets play a central role in economic growth and development by intermediating credit and enabling management of financial risk. They provide valuable investment avenues for investors and a pool of resources which support the growth of Australian businesses. Care must be taken to avoid tax measures that ‘put sand in the wheels’ of the financial system, as making it less effectual would impose a high cost on the economy. However, well-designed tax reform can reinforce other government policies, such as promoting competition in banking, developing a retail bond market and enhancing Australia’s competitiveness as a financial centre.

Australia relies on foreign capital inflows to finance balance of payments deficits and to support economic growth. Financial institutions raise funds overseas to on-lend to business and facilitate capital raising by Australian companies in overseas markets. The tax system should support the cost effective financing of Australia’s capital requirement and our financial system’s competitiveness.

### **1.7. IT Cost Apportionment**

Regulatory charging regimes should not create risks to this success. Yet the proposed IT cost allocation regime could introduce material changes to the market microstructure. The proposal in regard to IT cost apportionment violates at least four of the policy principles that we put forward in section 1.6.

In relation to the fairness principle it is not reflective of the level of trading activity (either by volume or value) and is unrepresentative of the supervisory effort required. It risks damage to the international competitiveness as it creates a disincentive for market makers to participate in the Australian marketplace. It goes against the industry competitiveness principle in that it discriminates between classes of participants and in terms of market neutrality it favours unlit venues over lit.

#### *1.7.1. Neutrality Between Participant Types*

The proposition put forward in the Consultation Paper is that the IT cost apportionment proposal is neutral with respect to different participant types.

*An added benefit to the wider industry is that this cost recovery approach is neutral between participants. Participants with low message intensity will pay lower fees compared to participants with high message intensity.*

While the principle of neutrality with respect to different participant types is acknowledged, the argument that participants with lower message intensity will pay lower fees than those with high message intensity does not amount to a neutral outcome.

While trade costs should be proportioned across participant types, that is not the case for messages. The ratio of message to trade count as one of the defining features of some market participants, in particular market makers that utilise HFT technology. As such it cannot follow that any outcome that discriminates on this basis between participants is neutral.

As stated previously the policy case for discrimination against these market participants engaged in HFT has not been made and cost recovery implementation is not the appropriate policy, particularly when policy consultation has not been carried out in respect of HFT.

#### *1.7.2. Neutrality to Venue Type*

Similarly, the IT apportionment methodology should be neutral with regard to venue type. In particular as the message traffic from dark pools, broker internal crossing engines and other off market venues is not captured by ASIC's system, these arrangements are not taken into account in the proposal.

#### *1.7.3. Alignment of Risk Analysis to Real World*

There are two questionable assumptions that are behind the justification to charge messages rather than trades, and these are that ASIC cannot know immediately what potential risk a particular message is to the market ('all messages are equal') and that IT processing costs are the same for all messages. Both of these assumptions do not stand up to scrutiny.

In the case of 'all messages being equal' it is clear that 'trade' messages are a much more likely candidate for investigation and risk to the market than 'cancel' messages, 'amend' messages, and 'place order' messages, with orders at very passive prices at far less risk to the market than more aggressively priced orders.

Similarly, messages are more or less of a risk to the market depending on the value of their content. For example an order for \$3 worth of stock will be much less of a substantial risk to the market than an order for \$3,000,000.

On the second assumption, messages that pose a higher risk to the market will, or should, take up far greater computing resources. For example a message that amends the price away from the market by one cent on 1000 shares can be readily filtered out of consideration versus an order to report a trade of \$40,000,000 worth of stock at a price that appears to be out of market. The latter should and would receive more scrutiny from the electronic systems.

As risk to the market should be considered when allocating IT costs, the allocation methodologies should not ignore differences in potential for risk to the market posed by different activities.

#### *1.7.4. Primary Drivers*

The primary driver for ASIC's IT costs remains, as for all supervisory costs, the disorderly or fraudulent behaviour of a very small number of people. It is not the great majority of the market that is working within the rules of the market that are driving these costs. The assertion in the Consultation Paper that it is market messages that drives costs misses this broader policy context in taking a more basic approach.

The cost for finding the trades and orders of concern should be shared at least proportionally by those responsible if not disproportionately with the rest of the market contributing on a fair and reasonable basis that does not interfere with good market practice.

Message based approaches to IT cost apportionment unfortunately does not achieve this objective. Given that very large numbers of messages to trade ratios are generated by market makers, large brokers and other reputable market participants it is likely the case that the businesses operating well managed fully compliant operations that are less likely to be in breach will be charged proportionately more, while rogues seeking to manipulate the market with a small number of illegal trades will be charged proportionately less.

#### **1.8. Charging in Arrears**

Another point to note is the tendency with advance charging arrangements to over or under charge. This problem can be overcome by charging in arrears, which is the normal commercial approach to billing.

#### **1.9. Risk Management Incentives**

Consideration should be given to structuring levies to incorporate incentives from a risk management perspective that generate a degree of levy relief for those institutions that can demonstrate effective risk management that drive appropriate behaviour. This would also help encourage the adoption of stronger risk management systems within regulated institutions.

As we have pointed out, the Consultation Paper fails to take into consideration the range of levies and other non-tax revenue measures imposed on financial institutions, particularly large conglomerates. In this regard, we would note that in addition to the AUSTRAC and APRA levies, major financial groups also face sizeable financial assistance

levies to reimburse government support to superannuation funds that fall into financial difficulties.

Our members are also very concerned with the absorption of penalties imposed by the Market Disciplinary Panel penalties into consolidated revenue. We have previously commented that the benefit to industry education funding was lost when the supervision regime was changed with regard to the disciplinary arrangements. This is not an appropriate policy change.

Consideration also needs to be given to the inappropriate signals that the proposed MDP funding arrangements send to the market. Poorly managed businesses should not be subsidised by better managed businesses. If a section of the industry or particular participant causes supervisory costs to increase (for example, generating excessive trades needing investigation and legal action), then the cost of this should be applied in a way that considers where they were driven from.

We do note the Cost Recovery Guidelines expressly prohibit fines and penalties being treated as cost recovery revenue to fund an activity as this creates regulatory conflict of interests by creating incentives by a body to impose a higher level of fines to increase its revenue. However, there is a significant disconnect between the activities and operation of the MDP and the flow of revenue to government from penalties. The benefit to government needs to be recognised in the CRIS and applied as an offset to recovered costs.

## 2. EFFICIENT ALLOCATION OF COSTS

*Table 2 Impact of ASIC costs relative to projected turnover*

Financial Year	2010 ASX est.	2011 ASIC	2012 Q1-2	2012 Q3-4	2013	2014	2015
Market supervision (\$m)	5.6	7.74	4.5	4.74	9.9	9.9	9.9
Competition (\$m)				6.16	8.97	6.72	6.31
<b>Total (\$m)</b>	<b>5.6</b>	<b>7.74</b>	<b>4.5</b>	<b>10.9</b>	<b>18.87</b>	<b>16.62</b>	<b>16.21</b>
<b>Cash equities turnover (\$b)</b>	<b>1359</b>	<b>1339</b>	<b>686.7</b>	<b>686.7</b>	<b>1373.4</b>	<b>1373.4</b>	<b>1373.4</b>
Growth (bps) 0%	0.0412	0.0578	0.0655	0.1587	0.1374	0.1210	0.1180
Growth (bps) 5%				0.1512	0.1309	0.1153	0.1124
Growth (bps) 10%				0.1443	0.1249	0.1100	0.1073
Growth (bps) 15%				0.1380	0.1195	0.1052	0.1026
Growth (bps) 20%				0.1323	0.1145	0.1008	0.0984
IIROC FY 2010	0.0625						
FINRA CY 2010	0.0815						

**Table 2** is derived from Table 7.1 in the Consultation Paper which models the basis points impact of supervision costs relative to projected turnover. Based on the underlying assumptions provided by the Government with regard to projected market turnover it is evident that the relative cost of regulation has greatly increased as a result of the transfer of supervision and is significantly higher than the costs in jurisdictions cited by the Government for comparison purposes.

In the light of our comments on the inappropriate allocation of costs in the model presented in the Consultation Paper we set out in **Table 3** below corrected allocations based on the estimated costs provided in Table 4.2 of the Consultation Paper.

**Table 3 Corrected allocations between groups**

	1/1/2012 - 30/6/13			
	Operators	Participants	ASIC	Combined
<b>Core function</b>	\$ m	\$ m	\$ m	
Market supervision	6.11			
Participant supervision		3.87		
Regulatory framework			5.13	
Investigations and enforcement	0.61	3.13		
MDP			1.64	
IT (amortised 5 years)	0.35	1.78		
ASIC shared services			2.17	
<b>Total</b>	<b>7.07</b>	<b>8.78</b>	<b>8.94</b>	<b>24.79</b>
<b>Percentage share</b>	<b>29%</b>	<b>35%</b>	<b>36%</b>	

Our corrected allocations are based on the application of these principles:

- Market supervision costs directly relate to the operation of the markets and should be properly allocated through the market operators.
- Participant supervision relates directly to the activities of market participant and can be allocated to them.
- Development of the regulatory framework is a cost of government and should not be cost shifted.
- Investigations and enforcement relates to regulatory oversight of the markets and participants and can be allocated between these groups.
- IT costs are a capital charge for an asset. In accordance with the Department of Finance and Administration the useful life of each asset is the estimated period of time over which it is expected to be able to be used and the cost of the asset should be amortised over this period. It is reasonable that the cost of IT be amortised over a 5 year period.

- The ASIC share of services are already funded and should not be cost shifted to the market supervision activity.

In summary the corrected allocations requires a total of \$15.85 million to be recovered which would be allocated \$7.07 million between the market operators and \$8.78 million between the market participants.

Assuming the proposed per trade approach equates to 0.05 basis points or about 7.5 cents for order of the size of \$15,000; it needs to be taken into account that three trades are typically required to execute an average retail order. In practice, this amounts to 22.5c per order, with a likelihood of further increases. As a result, incrementally increasing fees is likely to result in higher brokerage.

**Table 4 Impact of corrected costs relative to projected turnover**

	FY 2010	FY 2011	FY 2012	FY 2012	FY 2013
	ASX est.	ASIC	Q1-2	Q3-4	Q1-4
Costs (\$m)	5.6	7.74	4.5	5.28	10.57
Cash Equities Turnover (\$b)	1359	1339	686.7	686.7	1373.4
(bps)	0.0412	0.0578	0.0655	0.0769	0.0769

### 3. COMPETITION BENEFITS NOT IMMEDIATE

The Consultation Paper is overly optimistic in its assessment that competition is bringing benefits for Market Participants at this early stage. Competition in trading will lower costs in trading, but there are also increased technology costs that are likely to offset the lower costs of trading. There are benefits expected to clients through narrower spreads and over time the market will be more innovative because of competition, but no net benefit to brokers is expected from just the lower trading costs.

In the context of Table 7.4 of the Consultation Paper, the net effect of these factors means that the 26 bps is much too optimistic and will take longer to come into effect. Relying on the same underlying market turnover data and applying the standard 7% discount rate, the revised effect of a more realistic bps savings scenario over the forward estimates period is described in **Table 5** below.

Assessment of the benefits of the new competitive trading environment also needs to take account of increasing costs where competition does not exist, particularly in relation to clearing and settlement. At this stage rising IT costs of connecting to multiple market venues and the costs of regulation that are necessary prerequisites for competition are offsetting the benefits of lower trading fees.

While the logic is explained that ASIC costs are trade and message related it needs to be understood that brokers do not charge investors per trade or message. It is common for

brokers to charge customers brokerage per executed order. Whilst the number of trades it takes to execute a customer's order will vary, an average industry figure is that it currently requires around three trades to execute one order, which has increased in recent years from two trades due to falling trade sizes caused by the increased use of technology. It is reasonable to assume that the trade per order ratio will continue to increase due to developments in algorithmic and high frequency trading and the fragmentation of trading across multiple markets.

**Table 5 Exchange fee competition effects**

	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	Total
	\$ m	\$ m	\$ m	\$ m	\$ m	\$ m
<b>Headline</b>	-	1,448	3,266	6,035	5,403	<b>16,152</b>
BP 2 sided of turnover	0.000	0.011	0.024	0.044	0.039	
<i>Saving bps</i>	-	0.02	0.05	0.10	0.10	
<b>On order book X'ings</b>	-	158	136	401	609	<b>1,305</b>
BP 2 sided of turnover	0.000	0.001	0.001	0.003	0.004	
<i>Saving bps</i>	-	0.01	0.01	0.03	0.05	
<b>Off order book X'ings</b>	-	-	-	-	-	-
BP 2 sided of turnover	0.000	0.000	0.000	0.000	0.000	
<i>Negligible saving bps</i>	-	-	-	-	-	
<b>Subtotals</b>	-	<b>1,607</b>	<b>3,402</b>	<b>6,436</b>	<b>6,012</b>	<b>17,457</b>
BP 2 sided of turnover	0.000	0.012	0.025	0.047	0.044	

#### 4. SUMMARY CONCLUSIONS

The Government's underlying policy decision on cost recovery is flawed because it ignores existing excess ASIC related cost recovery measures and other contributions to revenue made by and through the financial services sector. The Government raises excess revenue through ASIC administered revenue measures that amounted to \$204 million in 2009-10. This excess revenue amount is continuing to increase and provides more than ample coverage for financial market supervision costs.

The Government needs a cohesive and consistent policy for cost recovery oversight and governance, which would allow the overall micro-economic impact of charges across the economy and particular sectors to be assessed and taken into account. The SCM regulatory burden estimate already amounts to around \$1.33 billion on the financial services sector per annum.

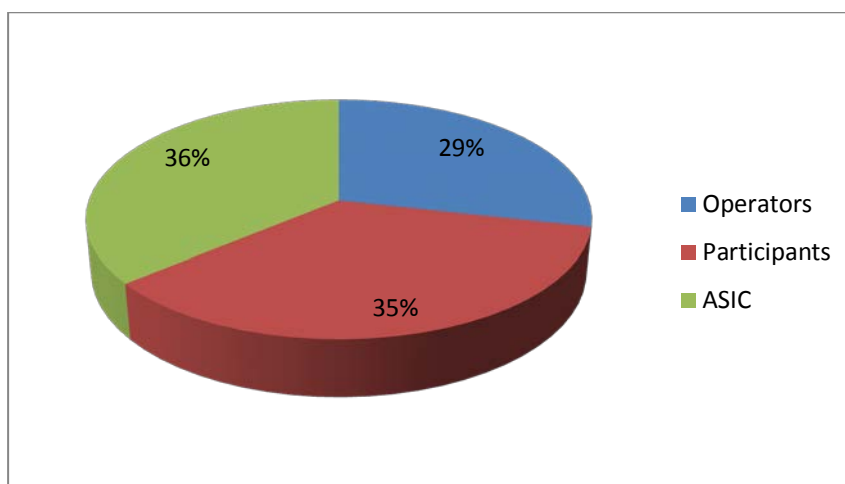
The proposal in the Consultation Paper:

- asks market participants to pay more than their fair share;
- makes incorrect allocations;
- underestimates the impact on the industry and investors; and
- overestimates initial benefits of competition.

Despite our disagreement about the need for the proposed cost recovery measure and its fundamental fairness, we provide, within the confines of the framework given in the Consultation Paper, revised cost allocations which go some way to addressing the fairness and equity of the proposal. In this context, \$8.78 million is fair recoverable amount for the period 1 January 2012 to 30 June 2013.

A revised allocation that properly allocates among groups would see them bear an appropriate share of the costs, as indicated in **Graph 2**.

**Graph 2 Shares of cost allocation**



In determining its approach to the allocation of IT costs to the market there are a number of principles that should inform the Government's approach which were set out in Section 1.6 of our submission.

Overall, AFMA considers that the Government needs to fundamentally reassess its policy analysis with a satisfactory Regulatory Impact Statement behind its decision to recover costs in the way proposed before it can produce an adequate CRIS. A failure to do so will result in flawed policy implementation because the inappropriate policy underpinnings and assumptions are being relied upon.

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