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Regulator Oversight and Engagement Unit
Treasury
Langton Crescent, Parkes
ACT 2600

By email: ASICIFMReview@treasury.gov.au

Dear Review Team

Review of ASIC's Industry Funding Model

The Australian Financial Markets Association (AFMA) welcomes the opportunity to provide feedback to the Treasury on the review of ASIC's Industry Funding Model (IFM).

AFMA has long made a case for such a review given that the current arrangements are inefficient, complex, and distortionary.

AFMA members continue to be adversely impacted by the volatility and inefficiency of the charges through multiple business channels. The volatility adds to the costs passed on to the end customers and investors, and the inefficiency creates negative impacts for the health of the markets and unnecessary costs for the broader economy.

We welcome Treasury's initiation of the review process and appreciate that it intends to comprehensively review ASIC's IFM.

Weight is placed in these comments on the desire to fundamentally rethink the ASIC IFM. AFMA takes this opportunity to highlight the need to have a deep and fundamental look at ASIC's IFM and seek more efficient ways for the Government to collect the revenue currently collected by the ASIC IFM.

Please note that our comments in response to review questions do not indicate that we accept the current model. In some ways our comments illustrate the irrationality, inefficiency and complexity of the current IFM and the need for change.

Australian Financial Markets Association
ABN 69 793 968 987
Level 25, Angel Place, 123 Pitt Street GPO Box 3655 Sydney NSW 2001
Tel: +612 9776 7993 Email: djeffree@afma.com.au

Should you require more information on this submission please do not hesitate to contact me on 02 9776 7993 or at djeffree@afma.com.au.

Yours sincerely

Damian Jeffree
Senior Director of Policy

Responses to Review Questions

Industry funding levies

1. Is it appropriate to continue to recover the costs of all of ASIC's regulatory activities through levies?

AFMA does not agree that it is appropriate to continue to recover the costs of all of ASIC's regulatory activities through levies.

At a high level we accept that the Government has an interest in raising funds from the corporate sector. Prior to the nationalisation of the corporate law in Australia the states similarly raised revenue from corporations via the state-based arrangements.

ASIC continues to be a significant revenue source for the Government even before measures associated with 'cost recovery' are considered.

As we will discuss there is often little true connection between the way fees are levied, for example a charge per trade, and the harms that ASIC is endeavouring to prevent such as insider trading. Reputable firms can process large numbers of trade with minimal risk of insider trading breaches. It is the disreputable individuals with a small number of trades that are the cause of the need for regulator search and enforcement, yet there is no effective way of levying these individuals in any significant way to assist with ASIC funding.

As such, AFMA is of the view that greater clarity of principle can be achieved by looking at the project as one primarily of revenue raising rather than one that is approximating charges for services rendered as for the most part the latter characterisation is inaccurate.

The ASIC IFM arrangements are a poor revenue raising set of measures as they are:

- Expensive to administer and collect: each year complex work is required by both ASIC and regulated entities to calculate various metrics used. This must all be signed off at the highest levels given the risks involved.
- Unpredictable: as we note below there is no way to know what the charges will be given the historical variability.
- Volatile: the volatility is an issue in itself that increases costs for investors as allowances are made for potential increases even when they do not materialise.
- Determined and payable 9 to 21 months after the taxable activity may have taken place: this creates problems in passing charges through to end users and creates inefficient intermediary risk.
- Have distortionary impacts on market activities: for example, message charges have discouraged market making, and came close to terminating market competition before it had begun, charges per OTC trader discourage employment and basing business activity in the region.

Given the role of markets in forming capital, these charges are arguably a tax on an input of production, which is also considered inefficient.

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Tel: +612 9776 7993 Email: djeffree@afma.com.au

> Economic analysis shows that taxes on production are the most harmful because of the distortions they cause throughout the production chain. Unlike corporate income tax or VAT, taxes on production directly affect companies' decisions in terms of choice of production modes and prices and can therefore penalise their productivity and competitiveness.[1]

There is simply no comparison with the efficiency and neutrality of a broad-based tax like GST or corporate tax and the IFM.

Best case for ASIC IFM

Even at a theoretical best where charges are known in advance and are levied in a way (such as per lot for futures) that are relatively easy to pass through to end-users, the IFM will have many of the undesirable features of financial transaction taxes.

An IMF Working Paper notes: "many distortions … militate against using an STT [Securities Transaction Tax] to raise revenue", as they "reduce security values and raise the cost of capital for issuers", "reduce trading volume" which "in turn reduces liquidity and slows price discovery", and are "an inefficient instrument for regulating financial markets and preventing bubbles" and "There is no convincing evidence that STTs lower short-term price volatility" with its costs likely passed on "not only wealthy individuals and corporations but also charities and pension and mutual funds". The paper concludes "More efficient tax measures should therefore be considered before an STT"[2]. While at a lower level than transaction taxes designed to raise general revenue, the cost recovery regime shares many of the downsides in terms of market impact.

Given the relatively modest amounts involved on a Federal Budget scale, and the downsides of even a best-case approach for ASIC IFM we believe there are more efficient ways to raise this revenue across the tax portfolio. Given the already large contribution of the sector and investors to the Federal Budget, the apportionment difficulties and the associated jurisdictional disincentives, these alternatives should be actively considered.

At a minimum the Government should acknowledge the public benefit of regulation and contribute significantly to ASIC's funding.

Reduction of budgetary incentives for ASIC

AFMA maintains that the IFM mechanism for ASIC reduces important budgetary pressures and disciplines. As Maddock *et al.* argue:

> The problem of 'slack' is quite standard across many entities, and government has developed a number of tools to address it. Having to compete for budgets, tough

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[1] Martin, P. & Trannoy, A. (2019). Taxes on production: The good, the bad and the ugly. *Notes du conseil d'analyse économique*, 53, 1-12. https://doi.org/

[2] Thornton Matheson, 2011. "Taxing Financial Transactions; Issues and Evidence," *IMF Working Papers* 2011/054, International Monetary Fund, p. 37.

scrutiny of annual reports, the requirement for efficiency dividends, and rigorous estimates hearings are some of the tools involved.

Regulatory bodies escape much of this scrutiny if they have their own source of revenue. It is hardly surprising then that regulators seek to be funded by industry levies rather than out of general taxation.

From the point of view of managing slack, industry levies should be discouraged because they weaken the incentives for monitoring:

- they reduce the incentive on departments to monitor agencies;
- they encourage a cost-plus mentality;
- the levied parties may be disinclined to complain about their own regulators; and
- they are a hidden tax on all relevant competing business which is likely to be passed on to consumers or other parties.[3]

There is a danger of regulatory creep if there is no direct cost to government from the introduction of new regulation. This may lead to regulation being over-supplied. Cost recovery arrangements should only be imposed as a result of a detailed assessment process that takes account of the full burden of regulation on the regulated industry, including compliance costs and the benefits to government from the industry's contribution to the implementation and continued operation of government regulation.

Current arrangements

The funding structure at present reflects ASIC's bottom-up view of the costs incurred in its regulatory arrangements. It then sets charges on an itemised basis to fund those arrangements by its regulated population. These arrangements do not generally reflect where the benefits of ASIC's work accrue, or, as noted, the parties that cause the need for regulatory effort.

A broader look at the ASIC-regulated community shows that a significant proportion of the costs are recovered from predominantly large institutions that must pay at multiple different levels and points within their organisations towards ASIC levies. This has resulted in a highly complex cost recovery system.

It is AFMA's contention that there are potentially more effective and useful ways to structure the revenue collecting process.

AFMA is encouraging a fundamental rethink which encompasses a comparative study across regulatory agencies and across jurisdictions; and undertakes an analysis into ASIC's IFM on a first principles basis.

[3] Rodney Maddock, Joe Dimasi, and Stephen King, "Rationalising Rustic Regulators: How Should Australia's National Economic Regulators Be Reorganised?," July 11, 2014, 19–20.

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2. Does the design, structure and legislative framework for levies remain appropriate?

Noting our views above that there are likely more efficient revenue raising measures, in our view the existing levy based on a mix of operational, FTE and financial data within each industry sector (which in some cases ASIC already has access to) and charges is overly complex.

Within the current paradigm we believe there is an opportunity to simplify the levy calculation and review alternative data measures which may be more available, appropriate, and standardised for determining the allocation of costs, for example, data metrics reported to APRA.

Futures Industry

In relation to futures markets participants we find that the current design could be improved.

As noted the details of the costs of transaction-based activities are charged up to 21 months after the transactions have taken place. Depending on the model of passthrough or absorption used by the intermediary, at the time of making their investment decisions, the end users may not be aware of the costs that they will eventually be charged. The retroactive charging process precludes users optimising their behaviour in line with the actual costs.

The method of charging, where executing brokers are charged for the number of messages that are sent to ASX and the number of trades that are executed is overly complex. It is not possible for Executing Brokers to pass these costs back to clients as there no simple way to control and monitor for the message count associated with each trade. For example, asset managers and hedge funds will often execute one large order and post trade allocate the trades to the underlying funds. In such a scenario, it is unclear who should pay for the messages that have been sent.

The combination of receiving the invoice 21 months after a transaction has taken place and the complex nature of the calculations, makes it difficult for the Executing members to pass back the underlying cost to the end user. It is often the case that the end client is no longer a client of the executing member at the time the invoice is received.

As such, within the existing paradigm AFMA supports solely using a “per lot” fee model similar to that used by the National Futures Association (NFA)[4] in America. This fee is associated to each futures trade and is a separate line item in futures statements. While there are some differences in the purposes of the ASIC Cost Recovery and the NFA assessment fee, the model gives market users certainty of the cost of regulation and accurately links the costs with the demands of clients and activities, creating the need for

[4] NFA Assessment Fee Model.

regulation. Critically the charge must not be subject to change after it is announced for the upcoming year.

This approach would allow clarity and certainty for investors, and for intermediaries to ensure they are implementing an efficient charging structure at the point of trade that is much less likely to result in unexpected and unbudgeted variances.

Double counting the number of lots traded by a large futures exchange participant

AFMA notes that currently, ASIC considers the strategy as well as the underlying legs of the strategy when totalling the number of lots, specifically for spread strategy trades. For example, trading one ten-year exchange listed roll strategy (consisting of two underlying quarterly futures) would be calculated as three lots. It is AFMA's views that this should only equate to two lots (the two underlying quarterly contracts) as they are ultimately the positions taken by the market user. This method of calculation essentially double counts lots and the fee charged to licensees.

OTC Trader

AFMA does not support the use of the OTC Trader count as appropriate for the calculation of cost allocation. In our view there are likely to be better metrics that can be used now that the system has been established for several years. ASIC may have views on options in this regard.

For the time that the OTC Trader metric remains in use, a key priority for the industry is to resolve the uncertainties around the OTC trader metric used in calculating cost recovery allocations. For a fair distribution of substantial costs for the industry it is important that there is a common understanding of the application of the OTC trader count methodology.

There currently is a lack of certainty around the intended application of the definition, particularly in relation to staff that might work for two or more entities, and staff that may execute occasional bookings to an entity where this activity is not ordinarily carried out by them.

AFMA understands that the OTC Trader metric currently could potentially be read on a technical basis to include overseas staff working on foreign listed markets, such as US Cash Equities and Futures as only Australian listed markets have been excluded from the OTC Trader metric. The industry is of the understanding that this is not the intent of the metric. For clarity we would request that both domestic and international listed markets be explicitly excluded from this headcount metric. This clarity would be appreciated and aid consistency on approach across our members.

Firms are working on a good faith basis around the uncertainties but are keen to have the uncertainties resolved.

Enforcement Special Account

Even in principle cost recovery for ASIC's Enforcement Special Account (ESA) is unfair, as it charges the cost of an enforcement action against a particular person to all of the regulated entities in the relevant segment of the industry, that is to say the part of the industry that specifically did not cause the cost.

Further, the industry should not be charged for the recovery of enforcement costs where ASIC is unsuccessful in an action. To allow cost recovery in the event of a loss removes important incentives for ASIC not to undertake actions that are unlikely to succeed. It creates a 'heads I win, tails you lose' arrangement as far as ASIC's funding is concerned.

Similarly, double recovery should not be available where ASIC already receives monies from entities involved in an enforcement action to cover the cost of its related investigation and action. Ad hoc arrangements should not be required to address double recovery.

3. Do the industry sub-sector definitions, levy formulas and entity metrics remain appropriate?

The industry sub-sector definitions, levy formulas and entity metrics largely remain appropriate, notwithstanding some of our previously noted views on OTC Trader metric.

4. How significant is the cost burden of levies for regulated entities, and what is the impact of this cost burden?

The variability and large increases in cost recovery continue to be significant burden on regulated entities. These costs create high barriers to entry in Australia.

This negatively impacts Australia's attractiveness as a financial centre (which is a being discussed extensively within the government) to foreign participants and investors. AFMA hears directly from firms for whom the charges mean they decline to join or withdraw from the local markets, even while continuing to base themselves here for Asia business. We have very recently heard directly of another example of a firm determining not to proceed with activity in the Australian markets due to the regulatory costs and burdens.

Based on feedback from our foreign ADI members, the charges that are incurred in relation to futures businesses, represent a significant proportion of the income of these businesses. In its current form it is challenging to pass these charges on to end investors and therefore has a significant impact on firms' ability to grow business in Australia.

Fees for service

5. Is it appropriate to continue to recover the costs of ASIC's user-initiated and transaction-based activities through fees-for-service?

AFMA takes particular exception to the charges associated with Class Orders. The structure of the financial services legislation typically involves catch-all drafting complemented with various carve outs in the regulations and class orders means that class orders are an integral part of the system. Firms requesting them should not be charged simply to make the legislation work as intended.

These fees are significant and create a disincentive to update or tidy up poor or outdated regulation.

More generally, ASIC fees for service created significant barriers to the establishment and growth of businesses in Australia, with fees as high as $11,305 for market participant licence applications, $38,651 for market licensee applications for certain exemptions, $44,660 for complex changes to operating rules, $154,506 for a new market operator licence, $154,598 for a derivatives repository licence. We suggest the benefits to the jurisdiction of new entrants and agility within the system be factored into the level of cost recovery on many of these items.

These fees are charged to firms that are seeking to do productive economic activity in Australia in compliance with the law. Firms are paying for ASIC to confirm that their plans to do the activity are in line with the law. These checks are often onerous and delay the entrance of firms into the Australian market for many years. Some of our competitor jurisdictions manage similar processes in a matter of weeks or at most a few months.

There is little benefit to the firm of having a licence hurdle created and costs required to overcome it. Any net benefit, should there be one, is a public good if the licencing approach reduces the number of bad actors in comparison to a registration-based approach.

We would support a cost benefit assessment of ASIC's licencing regime.

6. Does the design, structure and legislative framework for fees-for-service remain appropriate?

Referencing of fees

AFMA members have noted inconsistencies in the way that fees are referenced.

- In some documents, fees are referred to in dollar value and in some instances referred to in cents.
- There are inconsistencies in referencing of the fee structure for example, the fees published for large futures exchange subsector refers to transaction and messages while 2020-2021 invoices refer to messages and lots.

Transparency and consultation arrangements

7. Are the existing consultation, reporting and transparency mechanisms in relation to the IFM appropriate, including the form and frequency, and the content of information provided?

As we have noted in our discussions, the actual charges received can vary significantly different than the expected charges, and the estimations can come out around the same time as the significantly different final.

We support that improving the accuracy of forecast rates or reducing the time to finalise actual costs, however, we note that fees should be knowable in advance.

Examples of significant discrepancies between estimates and actuals include:

- The 2019-2020 indicative fees for licensees that provide personal advice to retail clients on relevant financial products were $1,500 plus $1,571 per adviser however the actual fees charged was $1,500 plus $2,426 per adviser.
- The 2019-2020 indicative fees for over-the-counter traders were $1,000 plus $3,197 per FTE staff however the actual fees charged was $1,000 plus $4,011.46 per FTE.
- The 2019-2020 indicative fees for large futures exchange participants were $9,000 plus $0.004 per lot and $0.00070 per message however the actual fee charged was $9,000 plus $0.0114 per lot and $0.0019 per message.

The industry funding timetable is unpredictable each year and licensees are informed of key dates as they occur. The process of gathering business data metrics requires engagement of various departments within firms including onshore and offshore teams. The lack of certainty on key dates such as when data metrics are due and when invoices are issued, makes it challenging for market participants to plan and engage resources.

8. What, if any, additional information and/or consultation, reporting or transparency mechanisms would be useful?

AFMA notes from member feedback that reporting instructions from ASIC with respect to business activity could benefit from improved coordination with the industry. The reporting process is reported as lengthy and involves several individuals from different functions across the firm to collate, review and report.

The industry would benefit from earlier finalisation of reporting requirements and access to the reporting portal, to prepare and submit the data. Currently, the reporting forms and instructions become available in late July for submission in September.

Charges should be announced and fixed a year in advance. Any shortfall should be recouped the following year. This gives investors certainty when they are making their investment decisions.

We note as an example that the cost recovery for large futures exchange participants increased over 200% from the 2019/2020 estimated figure. While ASIC communicated that the cost of enforcement is the key driver of the increase, AFMA members have repeatedly noted that this explanation is particularly opaque. We support that there

should be clear communication and understanding of where exactly the costs originate from. The current process gives no visibility to where the funds are being spent, staff resources, litigation cases, the outcomes of these cases, etc.

IFM more generally across financial services regulators

While the comments are focused on the ASIC IFM, AFMA has generally contended over a number of years that the financial service cost recovery approach should have more regard to the overall compliance burden imposed on regulated entities and its implementation across the sector as a whole.

The economic rationale for cost recovery is in many cases weak and often at odds with the Government's own cost recovery guidelines and the conclusions of independent reviews of these arrangements.

Cost recovery often ignores the significant benefits flowing to government from the regulated activity.

As with ASIC IFM, in practice, it is difficult to map the costs incurred by regulators on to final goods and services being sold in a way that ensures that prices to consumers accurately reflect these costs. Cost recovery arrangements are typically levied on suppliers, rather than consumers, based on proxy measures of regulatory intensity such as the size of the regulated entity's earnings or assets. These proxy measures do not necessarily accurately reflect regulatory risks and costs and may instead be based more on administrative convenience or perceived capacity to pay.

It is usually thought to be efficient to levy suppliers on the basis that they will pass the cost burden on to consumers in the form of higher prices. Cost recovery arrangements typically assume some pass through of costs from suppliers to consumers. However, it is widely recognised that this pass through may only be partial depending on the relative price sensitivity of supply and demand. If consumers are more price sensitive than suppliers, then more of the cost burden will fall on suppliers. To the extent that the cost burden does not fall on the beneficiaries of regulation, then resource allocation is not necessarily improved. Because the statutory or notional burden of cost recovery may differ from the actual economic burden after pass through, there is often a lack of transparency about the burden of cost recovery.

Great store in the Government's Cost Recovery Guidelines is placed on the axiom that those who benefit most from regulation should bear its cost for reasons of both economic efficiency and equity. However, identifying the direct beneficiaries of regulation is not always straightforward. This in turn makes it difficult to devise cost recovery arrangements that effectively levy the beneficiary. In the case of financial institutions and financial services, regulation exists mainly to protect consumers in their roles as depositors and buyers of financial products and services.

Funding from the Federal Budget has the benefit of not imposing additional compliance and collection burdens over and above those already built into the tax system. The progressive nature of the income tax system, and the tax system as a whole, ensures that the burden of public expenditure on regulation falls on higher income earners, who are

likely to be larger depositors and consumers of financial services and therefore the more significant private beneficiaries of regulation.

Cost recovery arrangements should recognise the mix of private and public benefits flowing from regulation. This should be reflected in a mix of cost recovery and public funding through the budget. While it may be difficult to quantify relative private versus public benefits, this should not be seen as precluding a mix of cost recovery and public funding given that full cost recovery also often involves subjective judgements about a regulator's efficient costs and the risks and effort associated with the regulated activity. Partial cost recovery coupled with government funding can strike a better balance where there are significant public benefits from regulation, even if these may be difficult to quantify.

It is generally accepted, at least in principle, that cost recovery should be instituted for reasons of economic efficiency and good regulation and not to raise revenue. However, in practice, governments may impose cost recovery arrangements to improve the budget bottom line. In an environment in which the federal budget is under pressure from a number of sources, there is a danger that cost recovery arrangements will be imposed as revenue-raising measures at the expense of economic efficiency. There is also a danger that the revenue-raising motive leads to cost recovery arrangements being imposed in an ad hoc and uncoordinated fashion so that the full cost recovery burden of regulation being imposed on the regulated industry is not recognised by government. In the case of financial services, this regulatory cost burden may harm Australia's international competitiveness as a regional and global financial centre.

Cost recovery arrangements also ignore significant revenue benefits to government arising from regulation. Industry bears the often-considerable compliance costs of regulation, an additional cost burden over and above regulator's expenses. Product pricing already reflects this compliance burden, mitigating any over-allocation of resources that might otherwise result from the under-pricing of regulation. For example, much of the administrative burden of complying with prudential regulation falls on regulated institutions.

We note that the levy model served a key purpose when ASIC was developing its markets' surveillance capacity and market integrity coverage. This capacity is now established, and it appears that the use of the market surveillance system is likely being extended to a broader set of data sources and purposes which potentially assists other government agencies and uses beyond market integrity interests. This suggests that these costs should be spread across all the relevant industry subgroups.

As financial markets rapidly evolve with various technological advances, AFMA notes there is an increasing risk that ASIC's resources are directed at understanding and assessing emerging business models and novel markets and assets outside of the traditional markets, including crypto. Further, we note that recent regulatory changes apply beyond markets, including PDDO, and this is a substantial area where ASIC is directing its resources. ASIC should not be charging the equity market industry for its activities in these areas, for example, crypto monitoring.

AFMA also notes that there is not currently any Government body with holistic oversight of the overall burden to regulated entities arising from cost recovery for ASIC, APRA and

AUSTRAC, particularly given that AUSTRAC currently sits outside the Treasury portfolio. In this regard, AFMA recommends that the Government should centralise the administration of the funding models for ASIC, AUSTRAC and APRA to improve consistency, efficiency and fairness of the cost burden on regulated entities.