Australian Financial Markets Association

Submission to the Second Consultation on Proposed Industry Funding Model for the Australian Securities and Investments Commission

December 2016

Contents

Executive Summary

- ASIC should be appropriately funded to carry out its regulatory activities, and AFMA members are willing to pay their fair share of the costs of regulation.

- As a general principle, industry funding should not be used as a mechanism to address problems in fiscal management. AFMA supports a co-funding model that better recognises the mix of public and private benefits flowing from regulation.

- AFMA remains concerned that the proposed initial $240 million annual impost of industry (inclusive of existing levies) will raise the effective tax burden on the corporate and financial sector, distort business decision-making, push financial sector activity offshore or outside the regulatory perimeter, and weaken Australia's competitive position with respect to other regional and global financial centres. These predictable effects are all contrary to the Government's stated policy intentions – in particular, to lower the corporate tax burden over time and promote competition, innovation and efficiency in financial services.

- The Government should commit to conduct a formal independent, external review of the industry funding arrangements no later than 3 years after the arrangements commence to operate. The review should have a terms of reference including but not limited to:

    - Whether the arrangements adequately address ASIC's funding needs;
    - Whether the arrangements operate as anticipated at the time they commence, and if not, what changes might be necessary;
    - The equity and proportionality of the arrangements applying to different sectors and business types;
    - Whether the imposition of the funding arrangements has any unintended or undesirable consequences that need to be addressed;
    - The effect of the funding arrangements on financial markets and financial services business activity in Australia.

- AFMA has previously put forward a number of suggested additional transparency and accountability arrangements, which are outlined again in the response to Consultation Question 6. In our view, the 'engagement and accountability arrangements' proposed in the model address largely administrative issues, and do not look to issues related the timeliness and quality of regulation. While AFMA acknowledges the importance of ASIC's independence as a regulator, this comes with obligations to be open and responsive to external scrutiny of the way it conducts its activities and the outcomes of those activities.

- Some elements of the proposed model appear to rely on assumptions that are, in our view, not correct or may produce perverse or unintended outcomes – particularly in relation to investment banking, trading in derivatives markets, and trading in OTC financial products. These issues are described in the responses to the Consultation Questions. AFMA recommends further consultation on these issues to ensure that costs are assigned to appropriate entities and the same activities are not counted across more than one sector.

1. Introduction

AFMA welcomes the opportunity to comment on the consultation for the Government's revised industry funding model for ASIC.

AFMA remains concerned that the proposed $240 million annual impost on industry (inclusive of existing levies) will raise the effective tax burden on the corporate and financial sector, distort business decision-making, push financial sector activity offshore and/or outside the regulatory perimeter and weaken Australia's competitive position with respect to other regional and global financial centres.

AFMA notes that these predictable effects are all contrary to the Government's stated policy intentions, in particular, to lower the corporate tax burden over time and promote competition, innovation and efficiency in financial services. The Government has allowed short-term fiscal considerations to dominate its consideration of industry funding, to the detriment of other important policy objectives. This implies a lack of coherence in Government policymaking.

This submission reviews the case for industry funding of ASIC, before addressing the consultation questions posed by Treasury based on member feedback and seeks further clarity on a number of outstanding issues that have been raised through the stakeholder engagement process.

AFMA agrees that ASIC should be appropriately funded to carry out its regulatory activities, and members are willing to pay their fair share of the costs of regulation. AFMA supports a co-funding model that better recognises the mix of public and private benefits flowing from regulation. However, we believe it is important to highlight the potential for adverse consequences for financial markets and market development from the move to industry funding so that these concerns can be reflected in Treasury advice to Government.

The submission makes some recommendations for improving the model, in particular, putting in place a more rigorous transparency and accountability framework for both the proposed model and for ASIC.

2. Reviewing the Case for Industry Funding: Budgetary Considerations

Proposals to move ASIC to an industry funding model date back to the 1997 Wallis inquiry. ASIC proposed an industry funding model in its submissions to the 2014 Financial System Inquiry. The FSI Final Report recommended an industry funding model under the heading of 'Strengthening the Australian Securities and Investments Commission's Funding and Powers.' An industry funding model has been presented by ASIC, the FSI Final Report and some other stakeholders as a solution to perceived problems with the adequacy and predictability of ASIC's resourcing.

The FSI recommendation

The FSI Final Report maintained that 'the absence of industry funding means ASIC costs are not transparent to regulated industry participants. It also exposes ASIC to an increased risk of funding cuts that are unrelated to changes in the cost of delivering on its mandate.'[1] According to ASIC, its 'regulated population has also increased in size and complexity yet funding has not increased accordingly.'[2]

The argument for industry funding has proceeded from an assumption that Government can no longer be relied upon to adequately or predictably fund ASIC. Accepting this assumption sets a very bad precedent. In particular, it suggests that industry should bear the cost of the inability of successive Governments to prioritise their expenditure appropriately.

If competing Government expenditure priorities have adversely affected ASIC's capabilities and effectiveness, then this an argument for a change in those priorities to ensure that this core function of Government is properly funded. Such a change in expenditure priorities does not in itself require a change to an industry funding model. It does strengthen the case for longer term funding agreements between the Government and ASIC, as also recommended by the FSI Final Report. The Government can and should resource its regulators adequately to perform the functions the Government and the community expect of them.

ASIC was given additional funding by the Government announced on 20 April 2016. Yet it is interesting to speculate whether this additional funding would have eventuated in the absence of the Government's decision to cost recover this additional expenditure through existing levy arrangements. This is a good illustration of how industry funding eases the Government's budget constraint, leading to an increased appropriation for ASIC and reducing the Government and ASIC's incentives to realise efficiency gains.

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[1] Australian Government, "Financial System Inquiry Final Report," November 2014, 250.
[2] ASIC, "15-236MR ASIC Welcomes Consultation on Industry Funding," August 28, 2015.

Budget saving measure

It has become apparent that the main motivation for the proposed shift to an industry funding model is that Government has become increasingly unwilling to fund the administration of the regulation it imposes for the benefit of the community. This has also been the case with other regulators, such as AUSTRAC, where the Government has moved to an 'industry contribution' model that pushes the cost of general regulatory functions, some of which have public good characteristics, on to an increasingly narrow sub-set of the regulated population in a manner that is inconsistent with the Government's Charging Framework and Cost Recovery Guidelines. The Government's approach to funding AUSTRAC is difficult to explain other than as a budget saving measure.

The first Consultation Paper made the fiscal motivation explicit when it said that an industry funding model 'would also ensure that a greater share of general taxation could be allocated to Government activities that benefit society more broadly.'[3] According to the Minister for Finance, the Government's user charging framework 'will lead to additional revenue to support Budget repair and other policy priorities.'[4]

These statements demonstrate that an industry funding model is being pursued primarily as a measure to ease the Government's budget constraint. Statements such as these cannot help but arouse concern that the other arguments mounted for industry funding are a rationalisation for what is fundamentally a fiscal issue rather than issues of regulator efficiency, effectiveness, transparency and accountability.

AFMA does not accept as a general principle that industry funding should be pursued to address problems the Government has in choosing between different expenditure priorities or problems with balancing the federal Government's budget. These are issues of fiscal management that need to be addressed in the broader budget and tax reform context. They should not be viewed as supporting what is a fundamental change in the nature of the relationship between ASIC, Government, parliament and the regulated community.

It is undesirable for Government to be alleviated of the burden of funding from general revenue the administrative cost of regulation that it imposes for the benefit of the community. It is important that Government internalise the cost of regulation via its budget process. Otherwise, regulation is under-priced from the perspective of Government and may lead to an over-supply of regulation. This is a logical corollary of the argument that the beneficiaries of regulation should internalise its costs to ensure that regulated outputs or products are not over-supplied. Economic efficiency demands a

[3] Australian Government, "Proposed Industry Funding Model for the Australian Securities and Investments Commission: Consultation Paper" (Canberra: Treasury, August 28, 2015), 4.
[4] Australian Government, "Agency Resourcing. Budget Paper No. 4 2015-16," May 12, 2015, 5.

recognition of the mix of private and public benefits inherent in regulation of the type ASIC provides.

While industry benefits from a well-regulated corporate sector, financial system and markets, this is also true of society as a whole. Many of the benefits arising from regulation satisfy the technical definition of a public good: they are non-rivalrous and non-excludable in consumption. It is generally accepted that public goods should be funded by the taxpayer. The FSI recognised this argument in principle and in relation to ASIC's financial education/literacy function, yet financial literacy is now included in the revised model. While the FSI did not see this as an obstacle to industry funding, it did not give a compelling explanation for why public goods should be funded by industry rather than taxpayers more generally.[5]

The proposed industry funding model will lead to a weakening in the Government's incentive to maintain effective scrutiny and oversight of ASIC's costs and effectiveness. Governments can be expected to more readily acquiesce to demands from ASIC or other stakeholders for increased funding if it can be secured from industry without having to compete with other policy and expenditure priorities. It is interesting to speculate whether the increased funding for ASIC announced by the Government on 20 April 2016 would have eventuated in the absence of the ability to recover this funding through existing levy arrangements. This illustrates how industry funding serves mainly to ease the Government's budget constraint and reduce the need to prioritise its expenditure.

As Maddock *et al* have noted:

> *Some regulators have proposed that their regulatory activities should be funded by a levy on the parties being regulated, by licence fees or similar industry charges. This should be resisted. It reduces the degree of budgetary scrutiny on the agency and undermines a key lever for regulatory accountability. Rather than having to fight for an allocation in the budget process, justifying spending to an expenditure review committee, a regulator funded by an industry levy is taxing the parties that it is regulating*.[6]

The widely expressed view emerging from the FSI, that ASIC will be better resourced under an industry funding model, effectively makes explicit the assumption that ASIC will receive a more generous budget appropriation under a predominantly industry funded model than under the current predominantly taxpayer funded model. If this were not the case, then the shift to an industry funding model would not achieve the objective of improving ASIC's resourcing, as suggested by the FSI Final Report. If ASIC's resourcing is to be enhanced through industry funding, this does not suggest that ASIC will be under budgetary pressure to realise further efficiencies in resource allocation.

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[5] Australian Government, "Financial System Inquiry Final Report," 253.

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

3. Reviewing the Case for Industry Funding: Non-Budgetary Considerations

A number of additional rationalisations have been put forward for industry funding in the context of the FSI and by the Government that reflect considerations other than the need to improve ASIC's resourcing, without having to trade-off competing budget priorities. These arguments are unconvincing and are at best an effort to divert attention from what is a fundamentally an increase in the tax burden on industry. The main arguments that have been made are as follows:

(a) 'The absence of industry funding means ASIC costs are not transparent to regulated industry participants.'[7]

(b) 'ASIC has limited accountability to industry and consumers in the activities it undertakes and why it undertakes them.'[8]

(c) 'Regulatory costs can be allocated to those that create the need for regulation.'[9]

(d) 'Establish price signals to drive economic efficiencies in the way resources are allocated in ASIC.'[10]

Each of these arguments is addressed below.

(a) *Transparency*

The suggested improvement in transparency seems to rest on the Government's undertaking that 'if the Government introduces an industry funding model for ASIC's regulatory activities, additional accountability mechanisms would be introduced.'[11] However, this transparency is of no benefit to the regulated community in the absence of effective mechanisms by which the regulated community can hold ASIC accountable for its costs.

Moreover, to the extent that the degree of pass through of cost recovery fees and levies to end-users/final consumers is variable and not directly observable, industry funding will reduce transparency in relation to who ultimately bears the cost of regulation. This

[7] Australian Government, "Financial System Inquiry Final Report," 250.
[8] Australian Government, "Proposed Industry Funding Model for the Australian Securities and Investments Commission: Consultation Paper," 1.
[9] Ibid., 3.
[10] Ibid.
[11] Ibid., 4.

reduced transparency in relation to the incidence of regulatory costs may also lead to an over-supply of regulation.

(b) *Accountability*

ASIC's primary accountability is to Government. The Government already has accountability arrangements in place for ASIC similar to those that apply to other regulators. However, as noted in the previous section, industry funding could be expected to weaken the Government's fiscal incentive to maintain effective scrutiny of ASIC's costs and effectiveness. Additional accountability arrangements will be less effective if Governments have no fiscal incentive to use them.

The FSI and the first Consultation Paper implicitly recognised this problem in noting that additional accountability arrangements would be appropriate in the context of a move to industry funding. The potential effectiveness of these arrangements are discussed in a later section of this submission. However, the proposed arrangements do not create a mechanism through which the regulated community can promote efficiency in the regulator or regulatory outcomes.

Since ASIC has the ability to deliver adverse regulatory outcomes to the regulated community, often on the basis of the exercise of discretionary powers, the regulated community has little incentive to make representations to either ASIC or the Government about ASIC's efficiency or effectiveness. As Rodney Maddock *et al* have argued:

> *Requiring the regulated businesses to fund the regulator might seem appealing in that the parties 'using' the regulation are paying for it. But the structure means that regulated parties have very little incentive to complain about excessive charging or laxness by the regulator. They may indeed feel intimated. It sets up a 'customer-provider' relationship between the regulator and the parties it is regulating, while at the same time reducing the accountability of the regulator to its actual principal – the parliament. Put simply, it creates the wrong incentives*.[12]

With the Government responsible for determining ASIC's budget appropriation, ASIC's primary accountability will remain to parliament. Enhanced transparency and accountability are mainly of benefit in so far as they assist the Government and the parliament in holding ASIC accountable for its budget appropriation regardless of whether ASIC is largely taxpayer or industry-funded. Such arrangements do not require industry funding for their effectiveness and may be weakened by them. Indeed, such arrangements are only being proposed in this context because it is believed that industry funding makes them necessary.

[12] Maddock, Dimasi, and King, "Rationalising Rustic Regulators: How Should Australia's National Economic Regulators Be Reorganised?"

(c) *Allocating costs to those creating the need for regulation*

The Consultation Paper invokes the Australian Government Charging Framework and Cost Recovery Guidelines in arguing that:

> '*cost recovery as a pricing mechanism is appropriate where there is an identifiable individual, organization or group that receives the regulatory activity or creates the need for it. This ensures that regulatory costs can be allocated to those that create the need for regulation…Industry funding would ensure that ASIC's regulatory costs were borne by those that drive the need for regulation (and their customers, if costs are passed through). This aligns with the user-pays principle*.'[13]

The Australian Government Charging Framework maintains that this approach is intended to 'promote equity, whereby the recipients who create the need for a Government activity, rather than the general public, bear its costs.'[14]

ASIC's main regulatory function is to enforce the provisions of the Corporations Act. The Act addresses a wide range of Government regulatory intentions, but is mainly concerned with the effective functioning and integrity of corporate entities, retail and wholesale financial markets. For the most part, this regulation is designed to protect consumers, borrowers, and investors.

Even where ASIC supplies demand-driven services, this demand is ultimately derived from these broader regulatory functions. The need for regulation arises from consumer demand for the products and services produced by regulated entities.

Regulation is a cost rather than a benefit to regulated entities. Regulated entities benefit indirectly from a well-regulated corporate sector and financial system, but this benefit also accrues to society as a whole. It is non-rivalrous and non-excludable in consumption, satisfying the technical definition of a public good, which is more appropriately taxpayer-funded. As noted in the first Consultation Paper, investor education and financial literacy programs also have the characteristics of a public good insofar as ASIC makes this information freely available. Yet it is now proposed that these costs will also be recovered through the revised industry funding model.

The economic rationale for levying industry depends on the assumption that industry can pass these costs on to consumers and end-users. The second Consultation Paper rejects mandating legal pass through on the basis this is inconsistent with the Government's Cost Recovery Guidelines, but also maintains the Government 'will not be restricting entities

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[13] Australian Government, "Proposed Industry Funding Model for the Australian Securities and Investments Commission: Consultation Paper," 3–4.

[14] Australian Government, "Australian Government Charging Framework: Resource Management Guide No. 302" (Department of Finance, July 2015), 4.

ability to pass on these costs through normal commercial practices.' However, both the attribution of regulator costs to regulated institutions and activities and the subsequent pass through to consumers is necessarily very imperfect. The degree of pass through to consumers is not directly observable. Regulatory risk and intensity are not adequately proxied by the proposed industry funding model metrics. As noted above, there is a significant public benefit to regulation that is very difficult to embody in industry as opposed to taxpayer funding models. Past experience has been for Governments to ignore this public good aspect of regulation in designing cost recovery models, with levies applied more on the basis of administrative convenience and perceived capacity to pay than regulatory risk or intensity. Much of the regulatory risk addressed by ASIC arises from fringe players in the corporate sector, credit and financial markets. However, the proposed industry funding model levies entities on the basis of crude risk proxies that often mistakenly assume that bigger is riskier. This is not conducive to either equity or economic efficiency.

By contrast, a predominantly taxpayer funded model is an efficient and equitable way of levying the main beneficiaries of regulation, namely consumers and investors. AFMA supports a co-funding model that recognises an appropriate mix of public and private benefits from regulation. Financial products and services are for the most part normal or superior goods, meaning consumption of them rises with income. A progressive tax system efficiently and equitably levies the main beneficiaries of the general regulatory functions performed by ASIC. Taxpayer funding also does not impose additional compliance and collection costs on industry over and above those already embodied in the tax system.

(d) *Price signals driving economic efficiencies*

The Consultation Paper maintains that 'industry funding would drive economic efficiencies in the way that resources are allocated. Industry funding for ASIC's regulatory activities would establish clear price signals that would influence the behavior of regulated entities that create the need for Government oversight.'[15]

The Consultation Paper gives only one hypothetical example of this price signaling effect. It suggests that regulated entities will only seek licence authorisations for current as opposed to prospective business activities, reducing the supervisory burden on ASIC. This is not a compelling example. ASIC already has the scope to allocate resources based on the actual rather than prospective activities by licensees. Moreover, this example highlights the concern that such fees may serve as a barrier to entry and innovation and distort business decision-making. Stakeholder and AFMA member feedback indicates the proposed funding model will lead to a review and reduction in the number of licences held or the number of authorisations included on a financial services licence.

[15] Australian Government, "Proposed Industry Funding Model for the Australian Securities and Investments Commission: Consultation Paper," 4.

This can be expected to reduce the agility of licence holders in responding to emerging business opportunities, particularly given the lead times that can apply to new licence applications. Provided that a licensee has been able to demonstrate that it has the requisite skills, resources and competency to provide the financial services covered by the licence, the funding model should not be used as a mechanism to control the number of licences on issue or the number and type of authorisations that licensees hold.

In its first round submission to the FSI, ASIC claimed that a user pays funding model will generate price signals that will encourage self-regulation or co-regulation where the pre-conditions for such models exist as an alternative to regulation by ASIC. However, these pre-conditions are arguably absent for much of ASIC's regulatory activities. For the most part, ASIC-regulated entities do not have the choice of self or co-regulation as an alternative to current arrangements. Indeed, ASIC will have a strong incentive to disallow or lobby against such self-regulatory models if it is industry funded. ASIC's argument in this regard is akin to APRA arguing that cost recovery would generate price signals that would lead to self-regulated, unlicensed banks, which are an impossibility under Australian law.

ASIC also maintained that a lack of pricing may lead to over-use of its services compared to other more costly alternatives, for example, private legal advice. Yet ASIC can charge user fees for these specific, demand-driven services without having to adopt a cost recovery model for its regulatory activities, for which there is a much stronger case for general taxpayer funding.

Where ASIC's regulatory activities have identifiable beneficiaries, it is efficient to seek to recover the costs of regulation to ensure that market prices internalise the cost of regulation. The existing cost recovery arrangements flowing from the introduction of equity market competition and supervision are an example of the more selective application of the Government's Cost Recovery Guidelines, although even in this case, market supervision arrangements have a mix of public and private benefits that should be recognised.

4. Formal Review of Industry Funding Arrangements

The Government should commit to conduct a formal independent external review of the industry funding arrangements no later than 3 years after the arrangements commence to operate. The review should have a terms of reference including but not limited to:

- Whether the arrangements adequately address ASIC's funding needs;
- Whether the arrangements operate as anticipated at the time they commence, and if not, what changes might be necessary;
- The equity and proportionality of the arrangements applying to different sectors and business types;
- Whether the imposition of the funding arrangements has any unintended or undesirable consequences that need to be addressed;
- The effect of the funding arrangements on financial markets and financial services business activity in Australia.

The review should be conducted by an appropriate external body such as the Productivity Commission, the Australian National Audit Office, a professional services firm engaged by the Government, or an appointed review panel. This type of review, which should include detailed consultation with entities that are subject to the levies, will assist in addressing industry concerns about the lack of effective transparency and accountability arrangements. The findings of the review, and the Government's proposed response to any recommendations, should be made public.

AFMA has previously submitted that additional ongoing transparency and accountability measures are needed, in addition to the formal review after 3 years. These proposals are set out again in the response to question 6 of the Proposals Paper.

5. Responses to Consultation Questions

Consultation Question 1: Do you agree with the proposal that all of ASIC's regulatory costs should be included in the industry funding model, excluding ASIC's registry costs and criminal prosecutions incurred by the DPP?? If not, please describe your preferred approach and reasons for it?

AFMA supported the exclusion of financial literacy from the previous model and maintains that these costs should continue to be excluded. These programs fit the definition of a public good insofar as ASIC supplies this information for free and it is non-rivalrous and non-excludable in consumption. The programs are not a regulatory activity and directly benefit consumers rather than industry. The need for financial literacy programs derives from consumers, not industry. Financial literacy is independent of ASIC's other regulatory functions, particularly insofar as it could be carried out equally well by another Government agency, such as the ACCC, with no detriment to ASIC's regulatory effectiveness.

The Enforcement Special Account (ESA) should also be excluded from the model for the same reasons as the Commonwealth Director of Public Prosecution's litigation costs. The ESA falls within the scope of law enforcement. The Australian Government Charging Framework provides for the exclusion of 'law enforcement, defence and national security' where the Government deems this appropriate.

AFMA supports the exclusion of ASIC's registry business from the scope of the model.

Question 2: Will the proposed model design objectives ensure consistency of approach to setting levies and fees across ASIC's regulated population? Are there other objectives that should be considered? If so, why?

While the model design objectives are appropriate, it is questionable whether the proposed model is consistent with these objectives given the trade-offs that have been made between these objectives. Most notably, the objective of simplicity has generally been traded-off against the objective of proportionality. The lack of risk-based metrics for the application of the levies means that ASIC's regulatory activities are not well mapped on to the regulated population on a risk-weighted basis. Instead, levy metrics are generally based on measures of activity or size as a crude proxy for risk and regulatory effort. This is potentially highly distortionary and creates a poor set of price signals.

The objective of applying levies that are commercially-based is also violated in important respects. The Consultation Paper cites investment banking as an example of a commercially-based sub-sector, but the proposed model has a poor fit with the commercial structure and activities of investment banking in Australia (see also response to question 4).

Question 3. Do you agree with the proposed model for calculating levies? Is there an alternate approach you would prefer? If so, please explain why.

AFMA has previously pointed to problems with the use of activity and transaction/message-based metrics as a proxy for regulatory effort and risk. The use of such metrics is inevitably distortionary, creates cross-subsidies and is likely to suppress market activity, drive it offshore or to less regulated venues. The large impost on listed companies will harm public markets by reducing listing activity.

AFMA has received feedback to indicate that market share might serve as a simpler, more cost effective and proportionate metric for the application of levies. This approach would require that reliable and authoritative measures of market share for different entities and activities are available. ASIC is potentially well placed to compile such measures. AFMA suggests that the feasibility and desirability of this approach be examined.

Transaction and messaging fees are a type of financial transactions tax, which harms market liquidity and will feed through to the cost of capital and reduce investment. The proposed messaging charges will fall particularly heavily on high frequency principal trading firms, who are growing suppliers of liquidity in equities and futures markets. Institutional equities trading will be adversely affected given the growing use of trade execution algorithms to reduce transaction costs. The higher cost of trading can be expected to detract from market liquidity and may flow through to wholesale and retail investors. Research on the impact of Canada's regulatory cost recovery messaging charges shows a measurable reduction in market quality flowing from cost recovery.[16] High frequency trading is a highly mobile activity and HFT principal trading firms located in Australia are already largely focused on trading offshore at the expense of local markets.

Further clarity is required about the extent to which futures transactions and messaging are captured by the model given that not all futures transaction are reported into the ASIC Market Surveillance System in the same way as cash equities. The Treasury paper seems to be in error in referring only to cash equities, although this is corrected in the amended definitions in the Q&A Treasury circulated on 15 December.

There is considerable uncertainty among market participants and infrastructure providers in relation to how messaging charges will be defined and operate in the case of derivatives. AFMA's understanding is that orders and order book changes including amendments and cancellations, as well as order book purges will each count as individual messages and are all charged. There is particular concern about how the proposed model might affect different market activities and the futures roll. Further information on how messaging charges will be defined and operate for derivatives is needed.

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[16] Andrew Lepone and Alexander Sacco, "The Impact of Message Traffic Regulatory Restrictions on Market Quality: Evidence from Chi-X Canada" (University of Sydney: Department of Finance, 2013).

It would be preferable if cash equities and futures participants were separated into different categories and levied separately for the purposes of the model given that these are very different businesses. Cash equities and futures should not be charged on the same basis. As the model stands, the proposed messaging charges for futures participants will have perverse effects. In particular, charging for GTC order amendments and order book watching penalises suppliers of market liquidity and may put participants into a negative P&L position in the absence of revenue from subsequent transactions. Futures participants may be put into the position of paying out more in regulatory charges than they receive from executing trades on behalf of clients. Order book purges undertaken for compliance reasons will also be penalised by the model, which is a perverse outcome. The treatment of futures in the proposed model is overly complex and contrary to the model design objective that levies be commercially-based.

Member feedback has also indicated that turnover may be preferable to transactions or messages as a levy base. Members have also suggested that front office full-time equivalent employees (FTEs) might also serve as a levy base.

The model is skewed towards levying public markets which are more amenable to activity-based, auditable metrics than OTC markets.

The model generally doesn't distinguish between client-facing and non-client facing activity (such as proprietary trading), yet these activities have very different regulatory risk profiles from ASIC's standpoint. The model is also flawed in levying intermediaries rather than end-users. For example, local market infrastructure providers and broker/dealers are levied, but offshore firms, funds and traders are not.

Further clarity on the distinction between OTC and exchange-traded products is sought. We note that foreign currency swaps can be both OTC or exchange-traded, at least in part.

We note that the issue of whether levies and charges will be a taxable supply has yet to be resolved.

While there is scope for pass through of levies to end-users, such pass through is likely to be partial and highly variable across different markets and products. The ex post application of the levies makes explicit pass through particularly problematic. This ultimately reduces the transparency of the model by disguising the economic incidence of the model. AFMA suggests that Treasury undertake or commission a post-implementation evaluation of the industry funding model to gauge its economic incidence and its effects on market activity and quality. This should feed into an independent review process for the industry funding model (see below).

Question 4. Do you agree with the proposed definitions for industry subsectors and levy metrics at Schedule 1? Is there an alternative approach you would prefer? If so, please explain why.

The model is based on a misunderstanding of the role of entities commonly referred to as "investment banks" in Australian financial markets.

AFMA generally agrees with the description of "investment bank" in Table 3 of the *Proposed Industry Funding Model for ASIC Proposals Paper November 2016* at paragraphs 1.a) to 1.d). This activity is referred to as client facing as it is activity that assists clients to manage their funding needs, raise capital through equity capital and debt capital markets and undertake corporate transactions.

However, Table 4 in the Proposals Paper which sets out the proposed definitions of levy metrics, creates a link between "investment banking revenue" (which would logically be calculated by reference to the client facing activities described in the investment bank definition) and revenue from other dealing in OTC financial products including FICC market trading which might be wholly unrelated to investment banking activity, and not conducted by the investment bank.

Fixed income, currency and commodities (FICC) market activity is captured under the definition of investment banking, but this is not consistent with the way investment banks typically structure their business. The majority of wholesale FICC trading activity in Australia is undertaken by non-IB entities.

AFMA raised issues with the definition of investment banking in the first consultation, but it appears these concerns have not been understood or addressed in the revised model.

AFMA recommends that Treasury consults further on the definition of investment banking and FICC market activity and recalibrates the model on the basis of these consultations. Client facing investment banking activity and OTC FICC and equities trading should be separated for the purposes of the model, as there is no necessary connection between the two activities. This will likely require the introduction of an additional levy category to the funding model.

Further clarity needs to be provided on how institutional and wholesale FICC market activity is captured and how this reflects ASIC's regulatory effort. There needs to be more transparency in the attribution of regulatory effort to institutional and wholesale FICC markets. It should be noted that industry already pays for trade reporting through fees payable to DDRS which acts as ASIC's agent for the collection of regulatory data. It would, of course, not be appropriate for industry to be charged twice for the reporting requirement.

Question 6: Do you agree with the proposed engagement and accountability measures? Are there additional measures you would prefer? If so, please explain why.

As noted above, the move to industry funding represents a fundamental change in the relationship between ASIC, the Government, parliament and the regulated community. In particular, there are now significantly weakened incentives for the Government to effectively monitor ASIC's efficiency and effectiveness now that ASIC is to be funded through an industry levy. This demands a much stronger accountability regime than is currently in place or proposed in the Proposals Paper. The Capability Review of ASIC highlighted the need for a stronger accountability regime.

The main omission from the accountability framework is independent third party scrutiny of the funding model and whether it is realising the efficiencies that have been claimed for it. In the previous consultation, AFMA argued that the Productivity Commission should be given the role of periodically reviewing the model's methodology and make recommendations for improving its efficiency.

AFMA's experience with CRIS processes in relation to existing industry funding arrangements suggests that these measures do not provide opportunities for substantive input into the design and impact of these arrangements.

The Government's Regulator Performance Framework is also an inadequate accountability mechanism. As AFMA noted in the consultation on ASIC's key performance indicators, the Framework is overly reliant on self-assessment, does not assess regulator performance against mandate, nor is it intended to reduce regulation or change regulatory outcomes.

In its submissions to the Government's consultations on the Financial System Inquiry's Final Report and the proposed industry funding model for ASIC, AFMA urged the Government to put in place a rigorous accountability regime built around independent external scrutiny of financial system regulators. Key elements of such a regime for ASIC should include:

- The publication by ASIC of a service charter that guarantees the provision of high quality and timely regulatory services – this is particularly relevant for application-based services (i.e. licensing, relief from the law, lodgment of documents) but may also be relevant to supervisory and enforcement activities, which often entail substantial additional legal and advice costs for regulated entities even where the result is that no action is taken against the entity.

- The establishment of additional independent oversight arrangements including review of the cost recovery model by the Productivity Commission, and a stronger outcomes based focus in the Regulator Performance Framework.

- Publication by Treasury of an annual cost recovery statement that provides an updated time series of all cost recovery and 'industry contribution' levies by the Commonwealth broken down by industry sector to increase the transparency of the additional tax burden being imposed through these levies.

- The establishment of an external Oversight Board to improve arrangements for the governance and management of ASIC under an industry funding model. This would likely require amendment of the ASIC Act to reform its governance arrangements and allocation of statutory responsibilities. The Oversight Board should report to the Treasurer on ASIC's performance against its statutory obligations and Statement of Expectations. The Board could assist ASIC Commissioners in developing an organisational culture, policies, codes and procedures to enable ASIC to meet its obligations in the most efficient and cost effective manner. The Board would not be involved in operational matters requiring interpretation of the law or in matters involving individual regulated entities. The Board should be independent of Treasury and the ASIC Commissioners.

- Alternatively, the appointment of additional ASIC Commissioner(s) or other statutory officers charged with specific responsibility for ensuring prudent management of ASIC resources, with external and public accountability. While the Government's reluctance to create new regulation and red tape is understood, this needs to be balanced against the significant burden that will be imposed on industry and the importance of protecting the interests of those who will be obliged to fund ASIC.

- Establishment of an Inspector General of Regulation as a high powered but low cost accountability mechanism that could potentially be applied across the full range of financial system regulators (APRA, ASIC, AUSTRAC and ACCC) to support high quality administration of relevant laws. The Inspector General should have powers to compel documents and witnesses. In ASIC's case, this would balance the considerable powers it can exercise, especially under an industry funding model.

These measures would give industry and Government much greater confidence that the move to industry funding is consistent with maintaining ASIC's efficiency and effectiveness.

Question 9: What do you estimate the regulatory cost of complying with the new requirements in the model to be?

Member feedback indicates that there are potentially significant compliance and collection costs associated with the model. ASIC have stressed the need for the regulated population to assist in supplying data to minimise the costs that will be passed back to industry through the model, but the model already places much of this burden on industry. In particular, AFMA members have raised the possibility that additional transfer pricing arrangements will need to be put in place in accounting for cross-border transactions that are booked offshore and transfer priced back to Australia

AFMA has previously noted that funding ASIC through general tax revenue has the advantage of avoiding compliance and collection costs over and above those already embodied in the tax system. Funding ASIC out of general tax revenue is a more efficient and equitable model for resourcing ASIC.

While the Proposals Paper only cavasses direct compliance costs, in should be noted that the more important costs of the model are in its distortionary impact on levied activities/transactions, and reduced incentives to undertake activity within Australia or within the regulatory perimeter.