Submission to the Commonwealth Treasury
To: Senior Adviser
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The Treasury
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Proposed Industry Funding Model for the Australian Securities and Investments Commission

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Introduction

The Treasury's consultation Paper issued on 28 August 2015 proposes to introduce a new funding model for the Australian Securities and Investments Commission (ASIC), the Australia's corporate and financial services regulator. The submission discusses this proposal and puts forward an alternate funding model that may ensure ASIC's independence while alleviating any burden the industry funding model may impose on the regulated community.

If any of the responses require further explanation please contact Dr Marina Nehme at m.nehme@unsw.edu.au.

Summary of Observations made in this Submission

This submission strongly supports an alternate funding model: reliance on ASIC's registers to fund the regulator. Unlike the industry funding model, the proposed funding model in this submission does not add a burden on businesses. It also provides ASIC with flexibility to implement different strategies that will enable it to achieve its aims.

If the proposed industry funding model goes ahead, the following issues need to be seriously considered:

- Transparency is very important but ASIC should not be held accountable to businesses as such accountability may result in the capture of the regulator which may ultimately undermine the stability of the Australian corporate and financial system;
- The levy may be viewed as an impediment to competition; and
- The levy may be perceived as unfair in certain instances and this may negatively affect the relationship between the regulator and the regulated entity.

Alternate Funding Model

1. Shortage of funding

The regulator's method and source of funding are fundamental issues that have to be carefully examined: a shortage in funding may negatively impact the regulatory policies adopted by an agency and may stop the agency from achieving its aims.[1] Accordingly, it is crucial for a regulator's funding to be stable and sufficient to cover the regulator's expenses.

Despite this reality, since 2010, ASIC's budget has been on the decline even though ASIC's role has expanded exponentially over the years. For instance, ASIC was first established in 1989 after the government determined that the National Companies and Securities Co-operative Scheme which established the National Companies and Securities Commission[2] had 'outlived its usefulness'.[3] However, when first introduced, ASIC was referred to as the Australian Securities Commission and regulated the companies and securities industry.[4]

It was in 1998, as a consequence of the enactment of the *Financial Services Sector Reform (Amendments and Transitional Provisions) Act 1998* (Cth), that the words 'and Investments' were additionally introduced into the name of the regulator. This change in name indicated to the public that the regulator now had broader responsibilities for the protection of investors in the financial sector.[5] As such, ASIC regulates companies, financial markets, financial services organisations and professionals who deal and advise in investments, superannuation, insurance, deposit taking and credit.

In 2010, the role of ASIC expanded to cover consumer credit. Further, ASIC became responsible for the supervision of trading on Australia's domestic licensed equity, derivatives and futures markets. Finally, since 28 May 2012, ASIC took charge of the national Business Name Register. Consequently, this regulatory agency may be viewed as a mega regulator and very few regulators around the world rival its role and powers.

To ensure that ASIC is able to achieve its objectives, the regulator has been provided with a range of investigatory and surveillance tools as well as enforcement powers. However, without an adequate funding source, all these powers and tools would be useless as the regulator will not have the necessary resources to implement its policies. This issue of lack of adequate funding is flagged in Table 1.

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[1] Ana Carvajal and Jennifer Elliott, 'Strength and Weaknesses in Securities Market Regulation: A Global Analysis (IMF Working Paper, WP/07/259, 2007), 32.

[2] Walker S J, 'Australia Introduces a National Companies and Securities Co-operative Scheme' (1981) 9(ix) *International Business Lawyer* 352; Baxt R, Ford H A J and Black A, *Securities Industry Law* (5th ed, Butterworths, Australia, 1996) pp 3–6.

[3] Senate Standing Committee on Constitutional and Legal Affairs, Parliament of Australia, *The Role of Parliament in Relation to the National Companies Scheme* (1987) p 73.

[4] *Australian Securities Commission Act 1989* (Cth), s 1(2); Australian Securities Commission, *Annual Report 1991–1992*, p 5; Baxt, Ford and Black, n 1, p 7.

[5] Explanatory Memorandum, Financial Services Sector Reform (Amendments and Transitional Provisions) Bill 1998 (Cth) at [3.41]; Adams M and Green J, *Changes in Liability for the Superannuation Industry*, Research Report (Faculty of Law and Technology Sydney on behalf of Fund Executives Association Ltd, Sydney, 2001) Pt 1, p 7.

Financial Year	**1998–99**	**2000–01**	**2002–03**	**2004–05**	**2007–08**	**2008-09**	**2009-10**	**2010-11**	**2011-12**	**2012-13**	**2013-14**
Operating Expenses $m	**145.2**	**143.3**	**172.6**	**208.9**	**273.8**	**295**	**387**	**385**	**384**	**411**	**405**
Income from government and others $m	**146.7**	**144.2**	**172.5**	**208.0**	**291.9**	**308**	**381**	**348**	**339**	**367**	**351**
F/T Staff numbers	**1225**	**1221**	**1396**	**1570**	**1669**	**1698**	**1931**	**1893**	**1738**	**1844**	**1784**
Total numbers of companies	**1,149,297**	**1,224,207**	**1,299,985**	**1,427,573**	**1,645,805**	**1,700,891**	**1,768,526**	**1,839,772**	**1,921,545**	**2,012,241**	**2,118,666**
Fees raised to the Cth $m	**-**	**363**	**405**	**531**	**545**	**552**	**582**	**622**	**664**	**717**	**763**

Table 1. ASIC in a Snapshot[6]

[6] ASIC, *Annual Reports* from 1998 to 2014.

2. **What can be learned from Table 1?**

Table 1 highlights an alarming problem in ASIC's budget, a problem that was also acknowledged by the Senate Economics References Committee in 2014:[7] the financial limitations the regulator has had over the years have negatively affected its ability to investigate and enforce possible breaches of the law.[8] Since 2010, ASIC's budget has declined drastically.

One of the consequences of such a decline is that fact that ASIC's expenses have exceeded its income. This has also impacted the number of full time staff working for the regulator with the number of staff fluctuating over the last five years. Accordingly, there are less people available to monitor the entities that are regulated by ASIC even though the number of regulated entities has increased over the years.[9] For example, the ratio of companies regulated by ASIC to its full time equivalent staff numbers has increased from 938 companies to every one full time equivalent staff member in 1998–99 to 1187 companies to every one full time equivalent staff member in 2013–14.[10] Accordingly, ASIC is required to stretch its resources further than ever before. All this may stop the regulator from initiating litigations when they believe that a breach of the law has occurred.[11] Instead, the regulator may end up relying on administrative sanction or persuasion to deal with contraventions.

Accordingly, ASIC is no longer in a position to deal with all the complaints it receives which can account for the high number of submission the Senate Standing Committees on Economics has received from investors about ASIC's poor performance.[12]

3. **Alternate funding model**

To empower ASIC, it is essential to provide the regulator with the necessary budget to allow it to operate efficiently. While the Treasury Consultation Paper notes that an industry funding model may be the answer, this submission considers that a better alternative is to allow the regulator to use the fees it raised for the Commonwealth to subsidies its income. As shown in Table 1, ASIC raised $763 million in fees and charges for the Commonwealth in 2013-2014. Such an amount can go a long way to improve ASIC's budged and enhance its performance.

However, such an option has not been canvassed to consider its advantages and disadvantages. Instead the government is planning to privatise ASIC's registers which are the

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[7] Senate Economic References Committee, *Report on the Performance of the Australian Securities and Investments Commission* (Commonwealth of Australia, 2014) 23-24.

[8] See for example: Daniel Carpenter, 'Adaptive Signal Processing, Hierarchy and Budgetary Control in Federal Regulation' (1996) 90(2) *American Political Science Review* 283.

[9] Table 1 only represents one type of entities that is regulated by ASIC and that is companies. It does not take into account others such as directors, financial advisers and managed investment schemes.

[10] These figures are based on the information presented in Table 1. Further, it is important to note that the ratio would be higher if we take into account all the financial service providers, financial advisers, credit providers as well as market licensees that ASIC regulates.

[11] Lawsuits may be very expensive, especially if the alleged offender contests the charges. For example, ASIC's costs in litigation against Citigroup Global Markets Australia Pty Ltd were close to $1.5 million (ASIC, 'ASIC v Citigroup', Media Release 07–193 (11 July 2007). The court in this case held that Citigroup Global Markets Australia Pty Ltd did not engage in insider trading and did not breach the conflict of interest provisions under the *Corporations Act*: *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Ltd (No 4)* (2007) 160 FCR 35). Similarly, ASIC's costs in litigation against Rich were around $35 million (Andrew Carswell, 'Jodee Rich Cleared Over Collapse of One.Tel' *Daily Telegraph* (19 November 2009)).

[12] Senate Economic References Committee, above n 7, Appendix 1, 465.

source of this income. The key advantages of the proposed alternate funding model are the following:

- This model will ensure ASIC's independence as the regulator will not be beholden to businesses for its income.
- The funds raised from the register provides ASIC with more flexibility over its budget. It further has the potential to enhance its investigatory, enforcement and surveillance mechanisms. It may allow ASIC to retain specialised people in the regulatory field. This will especially be important when ASIC is relying on certain powers it has at its disposal. Additionally, if ASIC is granted the power to issue product intervention orders[13] then it will need additional qualified manpower to ensure that this power is used efficiently. More funds may also allow ASIC to move from desk-top to on-site reviews for initial risk-based assessment something that would be viewed positively by the International Monetary Fund.[14]
- Businesses will not have an added burden imposed on them in the form of a levy.

Under this alternate funding model, ASIC is still expected to be transparent in all of its dealing and to be accountable to the relevant authorities.

Industry Funding Model

At first glance, an industry funding model appears to be very appealing. It is a model that has been used in other jurisdiction successfully. The model will allow the regulator to have extra financial resources to implement its different strategies. It also seems a fair model as costs are proportionally borne by those who create the need for regulation.

While this is all true, an industry funding model raises a range of concerns which are the following:

- There is a risk of capture for the regulator;
- The system may be perceived as unreasonable and unfair by certain entities.

If the government adopts an industry funding model, the above two issues have to be seriously considered.

1. Risk of Capture

The Financial System Inquiry notes that 'ASIC['s] costs are not transparent to regulated industry participants'.[15] Accordingly, ASIC needs to enhance its transparency and reporting to industry participants and consumers, something ASIC has been working on for some time now. A better disclosure by the regulator may enhance the understanding of businesses and consumers regarding ASIC's supervision costs.

[13] Financial System Inquiry, *Financial System Inquiry Final Report* (2014) Recommendation 22.

[14] International Monetary Fund, *Australia: Financial System Stability Assessment* (IMF Country Report, no 12/308, November 2012) 25-26.

[15] As cited in Australian Government, 'Proposed Industry Funding Model for the Australian Securities and Investments Commission (Consultation Paper, 28 August 2015) 1.

However, ASIC should not be accountable for businesses or consumers. The current accountability mechanisms provide the correct balance of accountability as they hold ASIC accountable for its action while ensuring the independence of the regulator. Discussions such as the one in the consultation paper and the Financial System Inquiry about holding ASIC accountable for businesses by exposing 'ASIC to greater scrutiny of its regulatory cost' are self-defeating and may lead to the capture of the regulator.[16] It is not up to businesses in any way form or shape to hold ASIC accountable. There are other avenues that are currently available to ensure such accountability.

Further, any involvement of businesses in this process of accountability may lead to the capture of the regulator. This possibility is already there as ASIC's current structure which is based on stakeholder teams already allows the regulator to get too close to the industries it regulates. As such it is crucial to maintain ASIC's independence as capture will endanger the efficiency and stability of the regulatory system.

2. Unreasonableness of system

The industry funding model raises the following concerns from the business side:

- Businesses will now be paying a levy. This levy may raise the cost of running a business and may be problematic from that regard. It may dampen innovation too. However, of more concerns is the fact that certain regulated entities will be subjected under this model to a large levy. An example of such industry is the auditing industry. The question is then how would such a levy impact on the competition in the sector? Would the levy result in the closure of a range of authorised audit firms?

- Businesses may perceive the levy as unfair. This feeling may stem from the fact that a business may view itself as a good apple that has to pay for the misconduct of other businesses. This is especially the case, if they view that ASIC is targeting conduct that they consider irrelevant to them. For instance, if crowd-sourced equity funding is authorised in Australia, ASIC will have to dedicate a range of resources to protect consumers. Further, ASIC may initiate action against offenders in this area. Such monitoring and enforcement may be viewed by businesses as irrelevant to them and as such they may feel that the fees they are paying are not targeted toward regulating their industry. The development of a perceived unfairness by regulated entity is dangerous as it may lead to resentment and hostility toward the regulator. This may deteriorate the relationship between regulator and regulated community and result in minimal compliance by businesses with the law.[17]

- This feeling of unreasonableness may be accentuated when regulated entities discover they have to pay the levy and, additionally, they still need to pay to access ASIC's register when they are privatise. It is important to note that the Consultation paper

[16] Capture is the process through which regulated entities end up manipulating the regulators that are supposed to control and monitor them. For more on capture, see for example: Paul Sabatier, 'Social Movements and Regulatory Agencies: Toward a More Adequate – and less Pessimistic – Theory of "Clientele Capture"' (1975) 6 *Policy Sciences* 301; Michael Levine and Jennifer Forrence, 'Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis' (1990) 6 *Journal of Law, Economics and Organization* 167.

[17] Eugene Bardach and Robert Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (Temple University Press, 1982) 105.

seems silent regarding the fees that are imposed on proprietary companies. There is a mention of a $5 or $ 350 levy imposed depending on whether the company is a small or large proprietary company however there is no discussion about whether the other fees that currently apply on these companies may be changed. If the rest of the fees remain as they are, these businesses are not benefiting in any way from this new levy. They may view that the levy is an additional tax on their business.

As a consequence, introducing the Industry Funding model has to be carefully considered to ensure that it does not have a negative effect on competition and will not result in an entry barrier to certain industries. Further, more importantly, businesses need to understand that ASIC is free to decide its strategies and enforcement policies. It is not beholden to businesses in that regard. The levy is just a cost of business but is not, in any way, supposed to hinder ASIC's ability to plan and determine its enforcement policies.

Conclusion

The adoption of an industry funding model should be very carefully considered to ensure it does not negatively affect the relationship between ASIC and the regulated entity and it is not detrimental to competition. ASIC's independence should be made a key feature of any such reform and ASIC should not be in anyway accountable to businesses. This will create an unjustified feeling of self-entitlement by businesses that may be harmful to the regulator/regulated entities relationship and may result in either hostility between these parties or the capture of the regulator. While the issue of transparency should be promoted by the regulator, ASIC's existing accountability mechanisms are enough to ensure the protection of consumers. There is no need for additional checks and balances.

To avoid all these problems, an alternate funding model is proposed by this submission. This funding model is based on ASIC relying on funds generated by its registers to achieve its aims and objectives. Such a model will not result in the imposition of an additional burden on businesses and will ensure the independence of the regulator.

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