YIELDBROKER

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Corporations and Schemes Unit (CSU)
Financial System and Services Division
The Treasury
100 Market Street
Sydney NSW 2000

Yieldbroker Response to Proposed Industry Funding of ASIC Consultation Paper - Public Document

Yieldbroker has a long history of working collaboratively and effectively with Treasury and ASIC. We welcome the opportunity to provide feedback on Treasury's Paper *Proposed Industry Funding Model for the Australian Securities and Investments Commission.*

Executive Summary

While Yieldbroker fully supports appropriate and stable funding for financial regulators, we are deeply concerned that the proposed levy arrangements on Market Infrastructure Providers (MIPs) are out of proportion with the size of the Australian market. We fear that a short term benefit of temporary funding certainty will come at the cost of longer term undermining of the public good generated by infrastructure providers with an Australia focus.

Competitive market infrastructure requires significant upfront investment in technology and resources and there can be prolonged initial periods of little or no revenue. The proposed structure of significant upfront fees will discourage investment from existing operators and potential new entrants.

If the initiative proceeds as proposed we anticipate significant negative consequences for Australian MIPs' ability to innovate and respond to requirements and opportunities in an agile and efficient manner. This will represent a considerable disadvantage for Australia as a nation given that major structural changes are currently underway in global financial markets. The proposal will undermine Australian MIPs' competitiveness against larger global providers which enjoy significant economies of scale. It will also impact Australia's competitiveness in the region where our neighbours, including Singapore and Hong Kong, commonly have substantially lower fees and are marketed as hubs for FinTech innovation through various incentive schemes rather than regulatory imposts.

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General Comments

We support the concern raised in the AFMA submission that the consultation process appears to be directed at how to "carve up" costs rather than consult on the fundamental basis for, and scope of, an industry funding model. We would welcome a paper that clearly presents the goals and objectives and sets out a measured analysis of the different models under consideration including the advantages and disadvantages of each model.

Australia's financial sector represents 10 per cent of total value added to the economy and is likely to keep growing at a rate exceeding GDP growth[1]. Given the significance of this sector to the economy, we believe that achieving the right balance between a public funded and industry funded regulation, and the structure of how to apply fees that create the right incentives for market participants, is fundamentally the most important aspect of the proposal and should have been a separate consultation paper.

MIPs strengthen financial markets by providing shared utilities and efficiencies to all market participants, including government and regulators, and playing a critical role in fostering financial system stability. This is enshrined in the 2009 G20 commitment, to which Australia is a party. All G20 leaders agreed to a comprehensive reform agenda for these markets to improve transparency, mitigate systemic risk, and protect against market abuse. In relation to OTC Derivatives all G20 members agreed that[2]:

- all OTC derivatives contracts should be reported to trade repositories (TRs);
- all standardised contracts should be cleared through central counterparties (CCPs);
- all standardised contracts should be traded on exchanges or electronic trading platforms, where appropriate;
- non-centrally cleared (bilateral) contracts should be subject to higher capital requirements and minimum margining requirements.

Fundamental to this reform is financial market infrastructure which is at the core of three of these four objectives. We therefore believe that financial market infrastructure demonstrates many of the attributes of a public good. This should be taken into consideration when determining an appropriate level of cost recovery for MIPs.

[1] https://bluenotes.anz.com/posts/2014/04/is-the-australian-financial-sector-too-big/
[2] http://www.financialstabilityboard.org/what-we-do/policy-development/otc-derivatives/

We are particularly concerned that the proposed model is short-sighted in its objectives and intended outcomes. Whilst it will provide a short-term fiscal windfall to government, there is a high probability that it will have an eventual net negative impact to the industry and economy. In relation to Market Infrastructure Providers (MIPs) we assert there are significant potential downsides, including:

- Consolidation of MIPs, and therefore reduced competition, as the costs of providing infrastructure will favour larger organisations that can absorb these costs across larger or multiple markets;
- Markets currently licensed in Australia may move offshore to significant less costly jurisdictions, such as Singapore, where MIPs are actively being encouraged and incentivised to set up business in those locations;
- Similarly, platform providers choosing between Australia and other jurisdictions will choose another jurisdiction where the barriers to entry and operating costs are significantly lower. This will result in fewer choices for the Australian investor;
- In our opinion we, like most regulated entities in Australia, currently have a collaborative and open dialogue with ASIC. ASIC has also benefited from this dynamic and is generally held in a high regard amongst global regulators. It is probable that, as a result of this proposal, MIPs and other regulated entities will choose not to include the regulator in discussions unless absolutely necessary as doing so would increase cost recovery fees as a consequence. This will damage the collaborative relationships ASIC has enjoyed with the market to date;
- It has long been recognised by Treasury and ASIC that there has been a proliferation of exempt market licence holders because the current market licensing regime is often seen as too high a barrier to entry and not flexible enough to cater to the many types of market operators. MIPs that had historically made the investment into obtaining a licence receive some perceived benefits of being held to a higher level of authorisation. Now each licensee will need to perform a cost-benefit analysis because the costs of remaining licensed are substantial. As a result the MIPs that hold a licence may decide to seek an exemption instead, as these fees are significantly less and capped at $45,000. If this occurs, this will lead to a decline in the number of regulated licence holders, and a reduction in the level of oversight ASIC has over the Australian market;
- It is highly probable that the end user will ultimately suffer the increased costs as MIPs that can do so will pass on their costs to their customers who will in turn pass their costs on to the end user. A difficulty in doing this is that proposed levy arrangements are based on fixed amounts, which means it is likely that the end user will overpay for the increased costs as MIPs will not want to risk of a funding shortfall. In the end this proposal may well be viewed as new tax on at least 10% of GDP, being the contribution of financial markets to the Australian economy.

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Answers to Specific Questions

52. Are the proposed levy arrangements for MIPs appropriate? Why or why not?

Annual Fee

No, we believe the annual levy to domestic Australian market licensees are proportionately too high given the size of the Australian market.

In order to compete, Australian-based MIPs are generally expected to have fees that are in-line with, or cheaper than, global platform providers. This is because financial markets are inherently global in nature and unless there is a domestic location requirement, or other barriers to entry exist, switching costs to global MIPs are generally low. This places a cap on how high Australian licenced MIPs can set their fees. In addition, the Australian market is far smaller than the global hubs of the UK and US, which Treasury puts forwards as examples of international funding models. The table below provides a comparison of the daily turnover in key FICC (Fixed Income, Currencies and Commodities) markets, as these are the markets in which Yieldbroker competes.

Jurisdiction	Daily averages per market, in billions of US dollars (ratio to Australian market size)				Proposed Annual Fee Range
	IRD[3]	FX[4]	Govt Bonds	Total	
UK	1348 (20x)	2726 (15x)	15[5] (5x)	4,089 (x16)	£18.5-300k
US	628 (10x)	1263 (7x)	509[6] (170x)	2400 (x10)	No annual fee
NZ	3 (x0.04)	12 (x0.06)	0.5[7] (x0.17)	15 (x0.06)	No annual fee
Australia	66	182	3[8]	251	A$116-4,000k

As shown above, the UK and US jurisdictions have FICC markets which are approximately 10-16 times larger than the Australian market. The UK does charge MTFs an annual fee which is between £18,500-£300,000; while the US currently does not have any fees (annual or service-based) for any of the markets described above – only for equities. Similarly, New Zealand does not charge annual fees.

[3] Bank of International Settlements, OTC foreign exchange derivatives turnover, April 2013 (http://stats.bis.org/statx/srs/table/d12.1)

[4] Bank of International Settlements, OTC foreign exchange derivatives turnover, April 2013 (http://stats.bis.org/statx/srs/table/d11.1)

[5] UK Debt Management Office, Gilt Market, All GEMMs' Aggregate Turnover; run for 01/07/2013-30/06/2014, converted to USD using average annual FX rate (http://www.dmo.gov.uk/rpt_parameters.aspx?rptCode=D4J.1&page=Turnover/Aggregate)

[6] SIFMA, US Bond Market Trading Volume, Average daily volume for 2014 (https://www.sifma.org/research/statistics.aspx)

[7] NZDMO, D9 Government bond turnover tables, Non-repo data run for FY14 (http://www.rbnz.govt.nz/statistics/tables/d9/)

[8] AFMA AFMR 2014 Report, GDS Dynamic tab, Government Debt Securities Annual Turnover Summary, less 'In house Transactions', converted to USD using average annual FX rate

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Australia should on this basis be looking to charge fees which are at an absolute minimum 10x smaller than the UK, and this is ignoring that the US and NZ who currently do not charge any annual fees to FICC market.

Yieldbroker would encourage Treasury to look at examples closer to home, and more comparable to the size of the Australian market, such as Singapore and Hong Kong. Singapore charges SGD 10,000 for a Recognised Market Operator licence and Hong Kong charges between HKD HK$4,740 – HKD 35,000 for an annual Automated Trading Services authorisation. These markets are much better benchmarks of size for the Australian market.

Yieldbroker also encourages Treasury to consider the impact of these changes on Australian entities' competitiveness. We appreciate that MIPs licensed and regulated in an offshore jurisdiction should be allowed to have that licence recognised in the context of providing a market to Australian participants. However, these entities are in direct competition with domestic Australian market licensees. Under the proposed levy arrangements these entities would be classified as foreign market licence holders or exempt markets under the Australian regime. The cost of these authorisations are substantially lower than the domestic market licence fees. The disparity in these costs will be putting Australia market licensees at a disadvantage. We are also competing against the major and emerging Asian markets, and as indicated above, Singapore and Hong Kong have significantly lower fees for their regulated markets than Treasury is proposing for market licence holders.

Fees for Service

No, we believe the fees for service that apply to market licence holders are too large, not well structured and will promote unintended behaviour.

The proposed fees-for-service for domestic Australian market licensees are a flat $52,000 for Operating Rule changes and a flat $52,000 for varying conditions to a market licence. For most small to medium market licence holders these charges are significant and will impact project profitability.

The flat fee approach is very blunt and makes no recognition of the extent of rule/licence changes required. If an established market licensee makes a rule change this is commonly due to changing circumstances and will be narrow in scope, whereas a fledgling market is more likely to make extensive changes with greater potential consequences. A common, fixed cost creates an effective subsidy by established licensees.

Another effect of large fees is that market licensees will be discouraged from evolving their Operating Rules/Licence. Licensees will be less likely to innovate and try new ideas if they require rule changes. This will also likely result in rules being written with the associated cost in mind, i.e. they will be written in the most generic way possible so their application is broad and not necessarily in a way that provides clarity to market participants.

We do not believe that operating rule changes should be subject to a full cost-recovery regime due to the impact of innovation (see answer to question 54 below); however, if they are included we suggest Treasury considers an impost which considers the required effort. We would suggest that ASIC carry out an initial estimate of the work involved, which would be a brief review of the extent of changes proposed. The cost of carrying out this initial estimate should be subject to a minimum fee, at most $2,500. Such a fee is significantly more than the $150 charged in 2013-14, and should cover ASIC's costs for carrying out this initial estimate and act as a deterrent and/or early detection of frivolous or ill-conceived proposals. Based on the estimate provided by ASIC, the MIP could then make a decision to proceed with submitting the official notice of changes to operating rules under section 793D. In order to encourage innovation, we believe the final fee should be capped at a level significantly less than the $52,000 proposed.

53. Will the proposed levy arrangements for MIPs be competitively neutral? If not, why not?

The annual fee range applied to market licence holders is exceptionally wide ($116,000 - $4,000,000). There is no transparency provided into the breakdown. As such it is very difficult to assess whether the fees applied to each market licence holder are fair and competitively neutral.

An important concern surrounds the lack of transparency on how the amount to be recovered from MIPs ($13 million in 2016-17) has been derived. Similarly, while we appreciate that the cost to be apportioned to each MIP may be confidential, we would have expected the paper to have provided some transparency into the criteria that will be used in apportioning the costs to each MIP. We strongly believe that much of the effort involved in regulating MIPs in changing circumstances should more accurately be classified as policy work – particularly where those changing circumstances have been generated by government or inter-government initiatives.

Attachment F in the paper includes a pie chart indicating the breakdown on regulatory activities to be carried out by ASIC for MIPs, namely: surveillance, enforcement, engagement, guidance and policy. However, it then states that "costs are driven by its assessment of the risk that each MIP presents to the operation of Australia's financial markets". Therefore it is not clear whether the costs are being derived based purely on objective historical assessment of ASIC resources committed to each activity for each MIP, or also by some, perhaps more subjective, assessment of risk presented by each MIP. In any case, we suggest that each MIP be provided with a detailed breakdown and explanation of their individual proposed fee and some indication of relative position amongst peers.

Yieldbroker requests that further clarity is provided on the 'policy' category. Chapter 2 refers to policy development being out of scope, but policy advice (which is referred to as advice to government on the operational implication of Government policy initiatives and legislative changes) as being in scope.

54. Will the proposed levy arrangements for MIPs support innovation? If not, why not?

The proposed levy arrangements for MIPs will not support innovation; indeed it will present a significant barrier to innovation for most small to medium MIPs, particularly from Australian-based entities. The structure of the proposed levy arrangements is that it is based on upfront costs. In contrast the majority of market operators derive a significant portion, if not all, of their revenue from transactional based fees. The nature of innovating in the market infrastructure sector is that each project requires significant upfront investment in technology and resources. The payback period can be long and very often during the launch of a new innovation MIPs will have a sustained period of very little or no transactional revenue, both because it takes time to build the transactional flow and because often, in order to attract the liquidity, market incentives such as fee-free periods are required. In addition, the nature of this sector is that it can be highly competitive with significant barriers to entry. Consequently the proposed upfront fee arrangements will see MIPs having to record substantial arbitrary losses initially and take a risk that the innovation will be successful.

Furthermore, successful innovation is most often an iterative process particularly for first movers. Under the proposed model entities will be charged $52,000 for every iteration which results in a rule/licence change. Combined with annual fees in the range of $116,000-$4,000,000, ASIC could very quickly become the largest cost centre of an innovating Australian MIP.

As a result entities with innovative ideas will be incentivised to conduct their innovation in offshore centres where they will not be punitively charged for trial and error by the regulator.

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55. Do you prefer an alternative proxy for supervisory intensity on which to determine the levy payable by MIPs? If so, why is this metric more suitable?

The paper does not provide enough detail on what supervisory intensity means or the proxy currently being proposed in the context of MIPs.

It may be worth considering an approach of selecting one or two of the larger regulatory activity areas, such as surveillance and enforcement, where the costs associated with undertaking this activity are clear, transparent and proportional to market activity and risk. Furthermore, these activities are not linked to innovation and so would not unfairly disadvantage forward thinkers or first movers.

56. Should the costs of maintaining the AMRF be collected from the entity responsible for making the change or from all MIPs through the annual levies? Please give reasons.

We do not believe the cost of maintaining the AMRF should be collected from the entity responsible for making the change: As the paper points out, this would punish first movers. However, it should also not be shared by all MIPs, as the AMRF currently only applies to a subset of equity-based products at present. The cost of supporting the AMRF should be shared between all MIPs that support the relevant class of financial product. We would expect that if more classes of financial products are added then the MIPs that offer markets for those financial products will share the marginal costs associated with supporting the AMRF accordingly.

57. Should operating rule changes be funded by MIPs through annual levies or on a fee-for-service basis? Why or why not?

We believe operating rules should be excluded from the proposed levy arrangements due to their impact on innovation (see answer to question 54). However if they are subject to a levy we have suggested an approach in our answer to question 52.

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