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Financial System Inquiry  
GPO Box 89  
Sydney NSW 2001

Dear Sir/Madam

**Chi-X Australia's Second Round Submission to the Financial System Inquiry**

Chi-X Australia (Chi-X) is grateful for the opportunity of providing a further submission to the Financial System Inquiry (the Inquiry).

The submission is attached and covers three issues discussed in the Interim report:

- (i) the options for an ASIC funding model – Chi-X is of the view that the Inquiry should review the existing ASIC cost recovery measures and, for both the existing measures and any wider funding model, recommend the implementation of a regime that accounts for the 'public goods' in ASIC services and otherwise implements a genuine user pays regime;
- (ii) the role of the Council of Financial Regulators (CFR) and a body to promote international integration – Chi-X is of the view that an industry led body needs to be established to play a role in holding regulators to account and promoting Australia's financial markets;
- (iii) a competition mandate for ASIC – Chi-X is of the view that a competition mandate is essential for the regulators of Australia's financial services.

We hope that this second round submission is helpful in your further deliberations. Please do not hesitate to contact us if you have any queries.

Yours faithfully

Chi-X Australia

## CHI-X AUSTRALIA'S SECOND ROUND SUBMISSION TO THE FINANCIAL SYSTEM INQUIRY

### 1. An ASIC Funding Model

1.1.1 The Interim report solicits views on possible funding models for ASIC<sup>1</sup>. Market Operators and participants are currently subject to an existing ASIC cost recovery scheme that levies a charge on messages and transactions. This section of the submission outlines why the Inquiry needs to recommend the overhaul of those existing ASIC cost recovery measures and, for both the existing measures and any wider funding model, recommend the implementation of a regime that accounts for the 'public goods' in ASIC services and otherwise implements a genuine user pays regime. Chi-X understands that no work will be done on a new model for the existing measures while the Inquiry is reviewing the wider ASIC funding issue.

### 1.2 An ASIC Funding Model – Governance, Consultation, Implementation and Review

1.2.1 It has been stated that:

- (i) “[the transfer of supervision to ASIC] has seen the cost of market regulation as it applied to operators and participants rise from around \$5 million to \$26.53 million a year<sup>2</sup>”; and
- (ii) “Poorly designed [cost recovery] schemes risk structural harm to the economy even for modest revenue, require high levels of complexity in design, are costly to administer, lack transparency, and introduce undesirable conflicts of interest [and] the ASIC market supervision cost recovery program has been an example of a program that suffers from these flaws<sup>3</sup>”.

1.2.2 These observations highlight the need for the existing cost recovery measures, and any new ASIC funding model, to be subject to a genuine governance process that requires:

- (i) a transparent budgetary process on the proposed allocation of the funds collected and subsequent expenditure and service delivery;
- (ii) a genuine two way consultation and review process involving ASIC and industry and that works with the transparent budgetary process in (i) to address any disconnection between:
  - (a) the users from whom costs have been recovered;

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<sup>1</sup> See page 3-113 of the Interim Report and the request for views on the costs, benefits and trade-offs of moving ASIC to an autonomous budget and funding process.

<sup>2</sup> See the article *ASIC fees a threat to brokers' jobs* retrieved on 25 August 2014 from [http://www.afr.com/p/business/financial\\_services/asic\\_fees\\_threat\\_to\\_brokers\\_jobs\\_NJOEYSJLBfmi2LUxSf5n7L](http://www.afr.com/p/business/financial_services/asic_fees_threat_to_brokers_jobs_NJOEYSJLBfmi2LUxSf5n7L)

<sup>3</sup> See the AFMA Submission *Options for Amending the ASIC Market Supervision Cost Recovery Arrangements* retrieved on 25 August 2014 from <http://www.treasury.gov.au/~media/Treasury/Consultations%20and%20Reviews/Consultations/2012/Amending%20the%20ASIC%20market%20supervision%20cost%20recovery%20arrangements/Submissions/PDF/AFMA.ashx>

- (b) the basis upon which that user community was initially defined and the charges levied; and
- (c) the ultimate services provided.

1.2.3 In this context, Chi-X continues to receive queries from key clients on how the ASIC cost recovery charge they have been levied has been calculated and impacts on their trading on the Chi-X market. This reflects:

- (i) the lack of ex ante transparency provided to sophisticated market participants and operators on how the measures will impact on trading undertaken on different markets;
- (ii) the relative advantage the measures provide for trading that takes place on the ASX market.

1.2.4 As a start-up entity, Chi-X is not positioned to compete with legacy monopoly providers on a sustained campaign to influence decision makers:

*"..large companies enjoy power as lobbyists. When they are monopolists, the incentive to lobby increases because the gains from convenient new rules and laws accrue solely to them.."*<sup>4</sup>

1.2.5 Many other financial service companies will be in a similar position to Chi-X in the way they compete with dominant service providers. These circumstances bear out how transparency and genuine two way engagement is an essential component in the governance processes for any cost recovery measure.

### 1.3 An ASIC Funding Model - Public Goods

1.3.1 Many different stakeholders need and rely on the integrity and regulation of Australia's cash equity markets. As has been concisely stated by ASIC Commissioner Mr Greg Tanzer:

*The penalties that apply [to market misconduct] are really quite severe and they reflect the importance of market integrity to the Australian economy as a whole.*

*It's really important to the Australian economy. There are thousands of Australian public companies that rely on the market to provide an efficient source of funds and they employ directly or indirectly millions of Australians and on top of that there's many, many Australian superannuation funds that invest the retirement savings of millions of Australians.*<sup>5</sup>

1.3.2 Public goods are said to have two main economic characteristics:

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<sup>4</sup> See the article *Monopoly is a bureaucrat's friend but a democrat's foe* accessed on 13 August from <http://www.ft.com/intl/cms/s/0/b62b46cc-216d-11e4-b145-00144feabdc0.html#axzz3AnwrwsxX>

<sup>5</sup> Transcript at <http://www.abc.net.au/7.30/content/2013/s3667080.htm> retrieved on 1 February 2013

- (i) they are non-rivalrous (that is, consumption by one person will not diminish consumption by others); and
- (ii) they are non-excludable (that is, it is difficult to exclude anyone from benefiting from the good)<sup>6</sup>.

1.3.3 The comments of Mr Tanzer quoted above suggest that the market supervision and monitoring undertaken by ASIC is a “public good”: millions of Australians ‘consume’ the services provided by ASIC in respect of market integrity and it is not possible to exclude anyone from enjoying that benefit. That ASIC’s activities and systems in this area include public goods should be transparently reflected and accounted for in the funding model. It is also worth noting in this regard that it is stated in the existing cost recovery guidelines that cost recovery may not be appropriate for services that are public goods<sup>7</sup>.

#### 1.4 An ASIC Funding Model – Evidence on Existing Methodology

1.4.1 The current cost recovery regime is not user pays: it is based upon metrics that do not properly identify the entities creating the need for regulation or accurately measure the appropriate contribution of those entities that are identified. For example, the supervision activities undertaken by ASX prior to the transfer of supervision to ASIC included disclosure by listed entities. The ASIC reports on the supervision and surveillance of Australia’s financial markets confirm that the supervision paid for by cost recovery measures includes disclosure by listed entities<sup>8</sup>. Notwithstanding this, ASIC cost recovery does not take into account the “need for regulation” generated by issuer disclosure. Income from the issuers subject to disclosure requirements, which is in part dependant on the integrity of the disclosure processes policed by ASIC, continues to be the most significant income stream generated by ASX in respect of the trading activities that are subject to ASIC cost recovery<sup>9</sup>. It is not clear to Chi-X how this is a fair outcome.

1.4.2 The systems used to monitor Australia’s markets are also used to monitor and take action concerning trading activity by persons and industry sectors which are not the subject of cost recovery<sup>10</sup>. It may also be relevant in this regard that the Inquiry has identified the coherence and cogency of extending the coverage of the Market Integrity Rules beyond market participants to securities dealers that are “indirect participants”.

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<sup>6</sup> See page 23 of the Australian Government’s Cost Recovery Guidelines Australian Government’s Cost Recovery Guidelines, retrieved on 22 August 2014 from [http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost\\_Recovery\\_Guidelines.rtf](http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost_Recovery_Guidelines.rtf)

<sup>7</sup> See page 22 of the Australian Government’s Cost Recovery Guidelines, retrieved on 22 August 2014 from [http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost\\_Recovery\\_Guidelines.rtf](http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost_Recovery_Guidelines.rtf).

<sup>8</sup> See paragraph 56 of ASIC Report 405 – accessed on 22 August from [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep405-published-21-August-2014.pdf/\\$file/rep405-published-21-August-2014.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rep405-published-21-August-2014.pdf/$file/rep405-published-21-August-2014.pdf)

<sup>9</sup> See the ASX Full Year Results Annual Report for 2014 retrieved on 25 August 2014 from [http://www.asx.com.au/documents/asx-news/ASX\\_Ltd\\_Full-Year\\_Results\\_Annual\\_Report\\_August\\_2014.pdf](http://www.asx.com.au/documents/asx-news/ASX_Ltd_Full-Year_Results_Annual_Report_August_2014.pdf)

<sup>10</sup> See for example the following ASIC press releases: *New South Wales man jailed for market manipulation*, retrieved on 25 August 2014 from <http://www.asic.gov.au/asic/asic.nsf/byheadline/14-131MR+New+South+Wales+man+jailed+for+market+manipulation> and *Healthzone directors charged with market manipulation*, retrieved on 25 August 2014 from <http://www.asic.gov.au/asic/asic.nsf/byheadline/14-205MR+Healthzone+directors+charged+with+market+manipulation>

- 1.4.3 Broadening the cost recovery base would address counterintuitive results in the current regime by creating a greater nexus between the revenue streams generated by the activity in respect of which cost recovery is sought and the cost recovery measures. The user would pay. At present the measures ignore the multiple revenue streams that are generated from the activities that are subject to cost recovery.
- 1.4.4 The comments in section 1.3 on the public goods in ASIC's supervisory work are also relevant when assessing the current ASIC cost recovery methodology.
- 1.5 An ASIC Funding Model - the Impact of the Existing Cost Recovery Measures
- 1.5.1 Chi-X currently pays nearly fifty percent of its gross trading revenue to ASIC under a cost recovery regime that commenced at around the same time the Chi-X market was launched. The cost recovery measures initially threatened the viability of the Chi-X market during its crucial early stages: the daily value of trading on the Chi-X market for the first two and a half months after the cost recovery regime was introduced rarely rose above \$25m, and was often less than the value traded individually by each of the top 20 brokers on the ASX. Participants have provided consistent feedback that these extremely low trading volumes were entirely due to the way the ASIC cost recovery measures discriminated against those trading strategies essential for the success of alternate market platforms<sup>11</sup>. The discriminatory nature of the cost recovery measures is also reflected in the fact that Chi-X's share of the aggregate cost recovery fees paid by market operators (ie ASX and Chi-X) is over twice Chi-X's market share of aggregate trading.
- 1.5.2 The ASIC cost recovery fees charged to Chi-X are also manifestly disproportionate to what alternative market operators pay globally. For example, BATS Chi-X Europe is a listing entity valued at over US\$300m with daily trading volumes that are double digit multiples of that traded on Chi-X and yet it pays lower supervision fees to the FSA than Chi-X pays to ASIC: for the 2013/2014 financial year the respective payments were £450,000 and A\$850,000<sup>12</sup>.
- 1.5.3 These outcomes diminish the incentives for innovators in financial market infrastructure to come to Australia. The Australian Government Cost Recovery Guidelines state that cost recovery measures should not be applied where they are inconsistent with government's policy objectives or where they would unduly stifle competition or industry innovation<sup>13</sup>. There is therefore a real question as to whether the existing cost recovery measures contravene the Government's own guidelines.
- 1.6 An ASIC Funding Model - Conclusions
- 1.6.1 In these circumstances, Chi-X is of the view that the Inquiry needs to review the existing cost recovery measures and recommend that they be replaced with a genuine user pays system that

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<sup>11</sup> See pages 2-3 of the Chi-X submission on the Treasury Discussion Paper: Options for Amending the ASIC Market Supervision Cost Recovery Arrangements – dated 6 February 2013 and retrieved on 22 August 2014 from <http://au.chi-x.com/NEWS/REGULATORYSUBMISSIONS.aspx>

<sup>12</sup> The amount paid by BATS Chi-X Europe can be obtained on pages 20-21 of the FCA CP 14/6 "FCA Regulated fees and levies: Rates proposals 2-014/15, retrieved on 12 June 2014 from <http://www.fca.org.uk/your-fca/documents/consultation-papers/cp14-6>

<sup>13</sup> See principle two of the Australian Government's Policy as outlined in the Cost Recovery Guidelines, retrieved on 22 August 2014 from [http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost\\_Recovery\\_Guidelines.rtf](http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost_Recovery_Guidelines.rtf)

identifies a portion of the ASIC services as a public good. The options available for recovering the cost of the remaining ASIC services through a more genuine user pays regime includes those successfully implemented overseas:

- (i) the SFC in Hong Kong is primarily funded through a basis points charge imposed on contract notes;
- (ii) the UK Takeovers Panel, which has some of the responsibilities undertaken in Australia by ASIC, is funded primarily by a transaction based fee and fees levied on disclosure documents<sup>14</sup>.

1.6.2 Chi-X is also of the view that for any ASIC funding model to satisfy existing government guidelines it needs:

- (i) to expressly acknowledge and account for the significant “public good” components of ASIC services;
- (ii) genuine governance that imposes requirements of transparency on the budget and service delivery of the measures subject to cost recovery;
- (iii) transparency on the calculation methodology, competitive neutrality and how it impacts on innovation;
- (iv) an appropriate review process for genuine grievances on the operation of the regime.

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<sup>14</sup> See <http://www.thetakeoverpanel.org.uk/the-code/fees-and-charges>

## **2. The Role of the CFR and a Co-Ordination Body Promoting Australian International Integration**

- 2.1.1 The Interim report seeks views on the role of the Council of Financial Regulators (CFR)<sup>15</sup> and having a co-ordination body to promote accountability and provide economy wide advice to Government about Australia's financial integration<sup>16</sup>. Many public submissions to the Inquiry commented upon the need for a secretariat to promote Australia's financial markets and services, co-ordinate aspects of the interaction between regulators and act as a monitor in the implementation of key reform measures and policy strategies intended to advance Australia's financial markets.
- 2.1.2 The Council of Financial Regulators is literally a "non-entity" from an industry perspective. It is a regulatory body for regulators. The only framework for engagement by industry is that set by the CFR on a case by case basis by the regulators it represents. It has no email address or contact numbers. It is theoretically possible for Australia's financial markets to diminish in regional and global significance to the point of irrelevancy without the Council being required to act.
- 2.1.3 Chi-X is of the view that in these circumstances it is important for an industry led body to:
- (i) act as a co-ordinator for industry-regulator liaison with all the regulators of Australia's financial system;
  - (ii) play a leading role in holding regulatory authorities to account;
  - (iii) acts as an industry representative on the setting of strategies to enhance Australia's financial services and markets; and
  - (iv) promote international integration and Australia as a financial centre.
- 2.1.4 Chi-X is of the view that an industry body, funded upon a genuine user pays model that requires all stakeholders to contribute and staffed/resourced by persons from industry<sup>17</sup>, may be an appropriate mechanism for addressing some of the needs in this area identified in the Interim report and first round submissions.

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<sup>15</sup> See page 3-120 of the Interim Report

<sup>16</sup> See page 4-101 of the Interim Report

<sup>17</sup> The funding/staffing/resource model employed by the UK's Takeover Panel may provide some guidance in this regard.

### 3. Competition Mandates

- 3.1.1 Pages 3-121 to 3-129 of the Interim Report discuss the balancing of the sometimes competing objectives to which a regulator of financial services can be subject and how competition considerations may be appropriately incorporated into the legislative mandates of Australian regulators.
- 3.1.2 Chi-X is of the view that it is essential to incorporate a competition policy framework and/or a competition mandate into the regulation of Australian financial market infrastructure. Competition between infrastructure providers has been introduced in Australia in a way that has allowed ASX to retain a monopoly in multiple areas and market operators are often required to compete on the basis of pre-competition paradigms. This can make it costly and problematic for ASX competitors to launch new products, given that they must rely on ASX for crucial services. It can also allow ASX to:
- (a) interfere with competitors gaining access to, and ensuring interoperability with, necessary ASX market infrastructure;
  - (b) discriminate in favour of ASX products, services and market infrastructure;
  - (c) prevent new entrants from offering customers complementary products and services which must instead be acquired from the ASX, which is able to and does charge monopoly prices;
  - (d) exercise a disproportionate influence over policy settings and the development of market rules and regulatory oversight for areas in which it remains the incumbent operator.
- 3.1.3 The recent ASIC assessment of the ASX is a good example of how competition outcomes can be appropriately incorporated into ASIC's regulatory functions to address the matters listed in (a) to (d) above in a way that ultimately benefits all Australian investors<sup>18</sup>.

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<sup>18</sup> See paragraphs 158-169 of the ASIC Market Assessment Report 401 on the ASX Group retrieved on 22 August 2014 from [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep401-published-28-July-2014.pdf/\\$file/rep401-published-28-July-2014.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep401-published-28-July-2014.pdf/$file/rep401-published-28-July-2014.pdf)