SAFA Stockbrokers And Financial Advisers Association Limited

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Corporations and Schemes Unit (CSU)
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PROPOSED INDUSTRY FUNDING MODEL FOR ASIC – CONSULTATION PAPER
COMMENTS BY STOCKBROKERS AND FINANCIAL ADVISERS ASSOCIATION

We refer to the Consultation Paper issued in November 2016 (”the Consultation Paper”) relating to the Proposed Industry Funding Model for ASIC (“IFM”). The Stockbrokers and Financial Advisers Association (SAFAA) appreciates the opportunity to provide the comments below in relation to the Consultation Paper.

SAFAA represents the whole stockbroking industry across the spectrum, ranging from large investment banks with a predominantly wholesale client base, to large retail firms and down to small firms.

SAFAA appreciates the amount of work which Treasury has devoted to arriving at the IFM and Consultation Paper. We understand that the task was not without difficulty, and any changes in one area necessarily have corresponding impacts on other industry sectors. We note that this latest version of IFM has included some changes that are an improvement on the previous model released for consultation in 2015.

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EXECUTIVE SUMMARY

- Retaining Federal Government control over the ASIC budget through the budget allocation process is a positive feature. However, SAFAA is not confident that there are adequate measures in place to restrain the growth of the ASIC's budget, and strong, independent oversight and more transparency of ASIC's internal resource allocation is essential for fairness.
- Whilst the cost of ASIC Market Supervision under the IFM represents a moderate increase compared to the ASIC cost recovery scheme currently in place, stockbroking firms will face a very significant increase in the quantum of fees they will be required to pay as a result of the other levies under the IFM.
- The cost impact will be particularly large in relation to retail stockbroking firms, mainly due to the retail adviser fee. Firms employing a large number of retail advisers will face a massive cost increase.
- The view of Treasury appears to be that the cost of the IFM will have a minimal impact on industry and that industry should be in a position to pass these costs through to clients. Member firms have advised that the increases in ASIC contributions will in many instances be very large, and they will continue to find it very difficult to pass the costs through.
- The IFM contains a number of significant financial incentives for stockbrokers to cease providing personal advice to retail clients, or to stop dealing with retail clients at all. To the extent that members are able to pass through any of the costs under the IFM, the IFM will make the cost of advice more expensive. This is something the Government needs to consider carefully, in view of its often-stated objective of increasing the access of retail investors to affordable financial advice that is suited to their needs.
- The transaction and message fees are a step in the right direction compared to the corresponding levies under the existing ASIC Market Supervision cost recovery arrangements. However, there remain defects with the proposed arrangements. In SAFAA's view, a Hong Kong-style ad valorem transaction levy imposed by the Government would not have those defects. SAFAA remains of the view that the Hong Kong ad valorem model is vastly superior.
- The transaction and message levies for market participants should be divided into separate component for cash equities and futures. A transaction and a message are very different for each market, and should not be combined in the one bucket.
- It is difficult to comment on the impact of the investment banking fee, in the absence of an indicative figure. More work needs to be done to refine the design of the fee, including dividing the category into sub-categories. Broker-Firm fees and stamping fees should be carved out, as these are more in the nature of brokerage than capital-raising fees, and do not belong in the investment banking category.

Preliminary Comment – Budgetary Process

Before dealing with the specific items in the IFM, we make some preliminary comments in relation to the budget setting process.

We note that under this version of the IFM, the Federal Government proposes to allocate funding for ASIC's regulatory activities through direct appropriation from the Commonwealth Budget, with those appropriations being offset by the fees and levies charged to industry. SAFAA supports this position. SAFAA has consistently argued that the Government retain control over the ASIC Budget as a means of ensuring fiscal responsibility, and ensuring that ASIC is not free to grow its budget without any appropriate controls and oversight.

SAFAA however has residual concerns as to the level of restraint that will effectively be applied to the growth of ASIC's overall budget. Members are concerned that ASIC's budget is likely to continue to grow at a significant rate, and industry will simply have to foot the bill.

There is little detail about the proposed annual consultation process with industry that is to occur, or what level of influence stakeholders are likely to have on the matter. In this regard, we note that a Stakeholder consultation forum has been in operation for a number of years already with respect to the ASIC Market Supervision cost recovery that has already been in place, and the general consensus of our Members is that stakeholders have not enjoyed any influence at all through this process. There is a real concern that this lack of influence will continue under the arrangements proposed.

Members also question the extent to which the Government itself, with the best will in the world, may be in a position to resist ASIC's demands for funding increases in the context of market events and pressures that will arise.

In SAFAA's view, there are two important elements that are absent from the IFM:

1. Some form of independent body or group able to review ASIC's costs and budgetary processes on a periodic basis to assure industry as to accounting and fiscal responsibility;

2. More transparency as to how the amounts in each of the items in the "Anticipated ASIC expense" column are arrived at and the relevant industry sectors that generate the expense. This would assist stakeholders to better understand how ASIC allocates its staffing and resources.

Financial Adviser fees

High level of Retail Tier 1 Adviser fee

We note the indicative fee per retail adviser ($960 per adviser). The financial impact on a stockbroking firm of this fee will be very high. A large national firm with, for example, 400 advisers, will face a bill of an extra $384,000 per annum for this item alone. In the current economic and market environment, costs of that nature are very hard to absorb.

There appears to be an assumption that the cost of the IFM will have a minimal impact on industry and that industry should be in a position to pass these costs through to clients. Member firms have advised that they will continue to find it very difficult to pass any costs through for competition and other reasons.

It may be that some sectors of the financial services industry are well placed to pass on any overheads to users. The conditions pertaining to stockbroking do not permit this.

Members have raised questions as to the employment law implications of attempting to pass on a regulatory cost to advisers. The only other alternative to absorbing the cost would be to try to recover the cost from the client.

Stockbroking, as a whole, still charges on the basis of brokerage on transactions. Brokerage rates over the last 30 years have only gone down, not up, for reasons of competition. Investors shop around for the cheapest rate of brokerage, and if one broker were to put their brokerage up, they are likely to face losing their clients to one who does not.

The high fee per retail adviser is largely the product of ASIC's allocation of its resources. Members have expressed surprise that ASIC devotes $22 million to retail advisers, and $800,000 to advisers providing general advice (see Schedule 3, page 40). This results in a cost recovery levy *per licensee* of $920 under the IFM, a levy that is less than the cost *per one Tier 1 retail adviser*. Members have questioned this resource allocation, which has driven the level of resultant levies.

Given that the issue of advisers purporting to provide general advice but in actual fact providing personal advice has been flagged as a significant issue by ASIC, the resource allocation in Schedule 3 seems anomalous to Members.

In SAFAA's view, there are licensees, particularly in the "shadow broking" space, who may be already following a model of providing personal advice to clients whilst claiming

it to be "general advice" and this is likely to represent a major area of potential investor risk. We do not understand why this area has not received a greater resource allocation by ASIC, or why the contribution to ASIC from this sector should not be greater than is proposed in the IFM.

The level of charges in the IFM provide a number of strong financial incentives which Members argue are contrary to Government objectives. One would be to cease providing personal financial advice to clients, and limit advice to general advice only. Another would be to limit the client-base to wholesale or sophisticated clients only. In both cases, the fee reduction under the IFM would be significant. This would undermine the Government's often-stated objective to increase the extent to which retail investors obtain advice, particularly advice that is suited to their needs.

There is also another financial incentive for firms who are highly regulated Market Participants of an Exchange, governed by the Market Integrity Rules, to cease to be Market Participant and operate only as a Securities Dealer, thereby becoming liable only for the significantly lower Schedule 3 Securities Dealer cost recovery levy ($250 per firm plus the turnover component).

In summary, Members are strongly of the view that the Tier 1 retail adviser fee is not struck at the appropriate level for a range of important considerations, and is far too high.

Implementing an alternative Market Participant Adviser fee

There is an argument that there should not be one single "bucket" for advisers providing Tier 1 advice to retail clients. Stockbrokers advising retail clients do not warrant being charged the same fee as advisers in other financial sectors.

In support of this, SAFAA notes a number of reasons:

- Stockbrokers are subject to a high level of regulation under the Market Integrity Rules. They are the only class of adviser subject to the MIRs. The MIRs establish a web of obligations that put brokers to the highest standards in the financial sector, including requirements relating to governance, prohibited conduct, client relations and so on.

- As a reflection of the higher standards, the complaint levels against stockbrokers (including FOS statistics) are consistently low historically and are falling over time [In 2014, FOS complaints against stockbrokers had fallen to a total of 42, a 17% reduction on the previous year and 50% over the previous 5 years. Only 5 complaints related to advice].

- The higher standards imposed on stockbrokers have required a significantly higher $ spend on compliance systems compared with other parts of the financial sector, including:-

    - Compliance systems for monitoring the firm's trading activity and also the activity of the firm's clients
    - Systems for complying with obligations to report suspicions of insider trading or market manipulation by clients or other persons
    - Systems for monitoring best execution for clients

Under the IFM, no credit is given to stockbrokers for performing this role or for the high cost of the systems that have been implemented to comply with the higher levels of obligations applying to them. Rather, they will be required to contribute the same amount as everyone else.

It is questionable whether ASIC is, or should be, devoting as much of its resources to Tier 1 retail advisers who work for stockbroking firms as it does to other sectors where significant problems have occurred, such as financial planning or insurance brokers. Our members believe that their cost recovery levies may be cross-subsidising the work ASIC performs in relation to other financial advice sectors.

In recognition of the above, SAFAA strongly submits that there is ample justification for retail advisers employed by a stockbroking firm to pay a much lower adviser levy than the general Tier 1 retail adviser fee indicated in the IFM.

IDPS levy

Concerns have been expressed that the IDPS levy in year 1 is a flat fee of $47,000, whereas in Year 2 it is a graduated levy based on the IDPS activity conducted. As a principle, the levy should be graduated based on activity conducted. The logic for not applying this in all years is not understood.

Margin lending levy

Further to the immediately preceding comment, the levy for margin lending should also be based on the level of activity (i.e. the size of the loan book), and not a flat fee (which would be payable even if only a small amount of activity is conducted).

Transaction Levy

The re-designed transaction levy is a step in the right direction. A flat fee is better able to be recovered than a fee which is entirely unknown until after the end of the period, as is the case with the present levy model [namely, % of market turnover/message count].

However, the proposed model still has a number of problems which Members have identified. In SAFAA's view, a Hong Kong-style ad valorem transaction levy imposed by the Government would not have these defects. SAFAA remains of the view that the Hong Kong model is vastly superior to that proposed in the IFM.

Firstly, it will remain up to the broker to determine whether to pass the cost through to the client or to absorb the cost themselves. There is still some question about the extent to which brokers will pass the cost on, for the competitive reasons mentioned in the preceding section of this Submission. As mentioned above, many brokers remain of the view that this will be difficult to pass on because of the high levels of competition in the industry.

The often-cited philosophy underlying the Federal Government's Cost Recovery Principles is that the cost of regulation is imposed on the parties who give rise to the need for the regulation. The assumption is made that it is stockbrokers who are responsible for market supervision, as they are the intermediaries who execute trades on market. This analysis fails to attribute any responsibility to the underlying clients who are in reality the parties responsible for placing all orders, motivated by their own trading objectives, of which the stockbroker may have no knowledge.

Under the IFM, then to the extent that brokers do not pass on the transaction or messaging levies, the result will remain that many clients, including offshore institutional clients, will not pay anything towards ASIC's costs. Institutional investors drive much of the activity in our market, and derive value from being able to participate in a market that is well regulated and has a high reputation for integrity, however they will not be required to contribute anything towards the cost of this.

Under the current regulatory requirements, market participants are required to supervise the orders and trading of their clients, which as mentioned requires a significant expenditure of resources by the participant, and which provides an added layer of protection. The IFM should involve some recognition of this role, but it does not. Rather, the effect of the IFM is that brokers will pay twice for the supervision of the markets, once for their supervision and again for that by ASIC.

In SAFAA's view, this is a significant defect in the IFM, and one of the main reasons for SAFAA's support for a Hong Kong-style ad valorem transaction charge levied on the

contract note by the Government. SAFAA remains strongly of the view that this is a far better model for Australia.

An additional benefit of an ad valorem charge along the lines of the HK Model would be that it would apply more equitably between a large institution buying 1 million shares and a small investor buying 1000 of the same shares.

SAFAA Members have requested that Treasury outline the reasons why it prefers the model in the IFM to a model which is proven and whose superior features are demonstrable.

Passing through the Transaction and Messaging levy

Members have raised the question of how the transaction and messaging levies are to be collected, if it is the intention that a stockbroking firm be able to pass them through to the client.

Under the Cost recovery cycle (see page 15, Figure 4, Consultation Paper), we note that the cost recovery will be on an ex post facto basis. The indicative levies will be published in June, and then another one in October (as per Figure 4) (although it is not clear what the October indicative figure is meant to do).

If a licensee wishes to pass through the costs, it will need to start doing so on 1 July on the basis of the indicative levy published in June. Presumably a licensee will want to use a consistent figure throughout the Financial Year, and not change the figure on an ongoing basis.

However, the actual figures on which the levy will be based will not be known until invoices are issued in the January after the end of the financial year, according to Figure 4. In this regard, the result under the proposed levies is the same as with the existing levy mechanism.

If the indicative levy on which the licensee has been collecting amounts proves to be less than the amount in the invoice that is eventually issued, does this mean that the licensee has to wear the shortfall, or will it be allowed to add this to the following year's recovery? Furthermore, if the indicative levy was too high, and the licensee has over-recovered, what must the licensee do with the surplus?

These issues will need to be dealt with in the Regulations. These are considerations behind SAFAA's preference as referred to for the directly applied transaction levy that where any over or under-collections in any one year can be applied to the amount to be raised in the following year.

Separating Cash Equities from Futures for the Transaction and Messaging levy

We understand that Cash Equities and Futures are in the same “bucket” for the purposes of the transaction messaging levies. We submit that the two products should be treated differently, and warrant being placed into different buckets and the ASIC Budget for this item appropriately apportioned between the two areas.

A transaction and a message for shares and futures are very different. By way of illustration, the average 1 ASX 200 share equates to $11.65 in price, whereas the average notional 1 lot of ASX SPI, 3YB or 10YB futures is over $100,000. There needs to be a different mechanism for calculating the levy in each of the cash equities and futures sub-categories.

Investment Banking Levy

Members have commented that it is difficult to comment on the proposed investment banking levy, in view of the absence of an indicative figure for the % of revenue.

Some more work also needs to be done to refine the design of the levy, including dividing the category into sub-categories. Firstly, the definition of “investment banking” activities is very broad, and combines a number of very different activities. Whilst the definition might be appropriate overall, the activity of dealing in OTC derivatives deserves to be treated as a separate class of activity to the rest of the activities in the definition, for the purposes of arriving at basis for calculating the appropriate contribution to ASIC’s costs for supervising OTC derivatives.

Removing Broker-Firm and stamping fees from the “Investment banking” levy

The definition of investment banking is very broad, and the wording is wide enough to capture “stamping fees” and “broker firm” fees payable to stockbrokers.

These two types of fees are paid to stockbrokers in connection with capital raisings. However they are paid to brokers as a fee in recognition for their advising clients on whether or not to take up an IPO or other raising in the nature of brokerage, or generally facilitating the lodgement of the clients’ application forms.

Stamping fees and Broker-Firm fees are not fees paid for advising the issuer or underwriting the capital raising. Therefore, we submit that these revenues do not belong in the “investment banking” bucket(s) and should be taken out.

Stockbrokers' advice to clients have already been levied heavily in the areas referred to above for contributions to ASIC's costs, and therefore a levy on this activity should not be proceeded with.

Gross v Net Revenue

Members have voiced concerns about the use of gross revenue as opposed to net revenue for the purposes of calculating the investment banking levy.

Further to the previous section, brokers will commonly receive a broker firm fee or stamping fee and rebate the whole amount to advisers. Under the proposed model, if these two fees are not carved out as requested above, the firm will be levied with a fee but will have paid away all the income.

The issue would be resolved in respect of stamping and Broker Firm fees if they were taken out as requested, however it could still arise in respect of underwriting fees, where the underwriter or lead manager will engage sub-underwriters (including various layers of sub-underwriter), and the same income pass through those hands. Each entity would be levied an amount based on the same fee as it is rebated down the line.

We support the general approach that a simple cost recovery model that is cheaper and easier to implement is in general preferable to a model that is complex and costly. However, our Members are not convinced that charging a fee on gross revenue is the right approach in this case.

Recovery of the cost of the ASIC Enforcement Special Account Levy

We note that in the 2015 Draft Industry Funding Model, it was not considered appropriate that the cost of the ASIC Enforcement Special Account (ESA) be the subject of cost recovery, and the ESA was excluded.

Members are very surprised that this area has now become the subject of cost recovery in the latest IFM. No explanation has been given for this change of thinking.

Members are strongly of the view that ESA matters are special matters that should be funded by the Government as previously planned. Matters such as these are the subject of special consideration and decision-making, and these are matters for which ASIC and the Government should properly be responsible. It is not appropriate that industry

participants be responsible for paying for what could be large scale legal litigation matters when they have neither been responsible for generating the enforcement action, nor have any say in the conduct of the proceedings. Firms who conduct their business in an exemplary way should not have to pay for expensive litigation against an entity who may have contravened the laws. ASIC should rely instead on an order for costs to recover its legal fees.

CONCLUSION

SAFAA appreciates the opportunity to provide these comments on the IFM and Consultation Paper. We would be happy to discuss any issues arising from these comments, or to provide any further material that may assist. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3200 or email pstepek@stockbrokers.org.au.

Yours sincerely,

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