Daniel McAuliffe
Manager
Financial Markets Unit
Corporations and Capital Markets Division
The Treasury
Langton Crescent
PARKES ACT 2600

1 February 2013

Dear Mr McAuliffe

Re: Options for Amending the ASIC Market Supervision Cost Recovery Arrangements

Thank you for the opportunity to provide a submission.

The Financial Services Council (FSC) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, private and public trustees. The FSC has over 130 members who are responsible for investing $1.8 trillion on behalf of more than 11 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The FSC promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

Please find our submission enclosed. We look forward to discussing the contents with you. I can be contacted on 02 9299 3022.

Yours sincerely

ANDREW BRAGG
SENIOR POLICY MANAGER

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FSC SUBMISSION –
Options for Amending the ASIC Market Supervision Cost Recovery Arrangements

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This submission outlines the FSC's views on:

1. Context

The FSC notes that decisions on Australia's capital market structure are being considered whilst the industry and government are working towards developing Australia into a leading global financial centre.

It is therefore critical that decisions on market structure take into account the following key factors:

1. Australia's attractiveness as a capital raising centre;
2. relative competitiveness and strength of Australia's financial system globally and in the Asian region;
3. the potential for unintended consequences or negative trends in our capital markets; and
4. confidence, stability and investor protection.

Comparable markets in our region have employed varying regulatory approaches to market operation and supervision. For instance, jurisdictions such as Hong Kong and Singapore have a stamp duty on trading, which has resulted in lower algorithmic trading relative to Australia and Japan (which do not). Other nations such as Germany are proposing a swathe of new regulations to address High Frequency Trading (HFT) – specifically:

> Under its proposals the German government wants high-frequency traders to register with market regulators and disclose their secretive trading algorithms.
>
> It also wants to limit the number of decimal points given in market prices and prevent traders from requesting pricing information without intending to trade.[1]

There have been similar calls for varying regulatory responses in the United States and Australia. We believe that each proposed regulation needs to be considered carefully against the key factors above.

For this reason we undertook research in late 2012 to consider the impact of technology on Australia's capital markets. We draw on this evidence throughout this submission.

2. Cost recovery for capital market supervision

The FSC has supported the transferral of market supervision to ASIC; we believe it is important that ASIC is appropriately resourced to supervise Australia's capital markets. Robust regulation will support market integrity and confidence in Australia. To this end, appropriate budgeting of costs and cost recovery arrangements, which support the objective of necessary ASIC resourcing, is sound in our view.

ASIC requires resources to fund market supervision and technology solutions / IT. The strength and capacity of the technology will drive market integrity by assisting ASIC to detect misconduct. Accordingly this paper deals with how ASIC should recoup over $40m from the industry through to 2016 to meet its supervision needs.

The principle of cost recovery applies in this context as the capital markets have created the need for regulation which needs to be funded. Accordingly the FSC agrees that it is appropriate that the industry should be subject to cost recovery to pay for the expense of regulation. The

[1] Reuters - http://www.reuters.com/article/2013/01/28/germany-regulation-idUSL5N0AX9DV20130128

Australian Government Cost Recovery Guidelines (**the guidelines**) specify circumstances where the need for regulation justifies cost recovery.[2]

Our focus is on expenditure of levied monies and the manner in which they are raised from the industry. This should occur in a cost effective, efficient and consistent way. The guide is instructive in outlining the design and implementation of cost recovery mechanisms. It focuses on the above three factors.

The guidelines state:

> Therefore, to meet their transparency obligations, agencies should adopt costing models sufficiently detailed to allow the Parliament, the Government and, where relevant, stakeholders to analyse their production costs.
>
> Agencies should develop clear costing models detailing actual costs, and how those costs relate to prices and be able to provide information on how capital costs are calculated and how capital costs and overheads are allocated among products.
>
> The adoption of detailed costing models is also necessary in case the validity of the fees is challenged and an agency needs to demonstrate that the fees are authorised by the legislation - imposed on a basis that is consistent with fees rather than taxes for constitutional purposes. [3]

In other words, the cost of monitoring and enforcing regulation drives cost recovery arrangements. The FSC believes this is an appropriate guiding principle for cost recovery in financial market supervision.

This submission focusses on the appropriate cost recovery arrangements and seeks to answer a number of the questions posed by the Treasury.

3. HFT / cost recovery arrangements

In late 2012, the FSC released research into the impact of technology on Australia's capital markets. In particular, this work focussed on dark execution and high frequency trading (HFT) in Australia.

This research, independently undertaken by Baseline Capital, forms both a quantitative and qualitative study of both factors – including a literature review and interviews.

In assessing the impact of HFT, the research demonstrated that while HFT (or for that matter any technological development) could adversely impact market stability and integrity, there are positive impacts and the negative element can be managed by regulation.

The following summarises the view on HFT:

> Much of the academic research supports the idea that HFT activity (or perhaps more accurately algorithmic trading activity) improves market quality – higher trading volume and liquidity, reduces posted spreads, lower volatility and better price efficiency. However, there is also increasing doubt within the literature regarding the data and methods of testing. The *potential* for destabilising and predatory behaviour exists as well - while there is little direct evidence of truly predatory HFT behaviour in Australia, estimates would put it at a maximum of 5% of all volume (that is, around 20% of HFT, which is itself 25% of trading volume). Predatory HFT seems to be characterised by the ability to learn from participation rate trading, differential latency, high message cancellation rates and non-existent "market making" behaviour.[4]

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[2] http://www.finance.gov.au/publications/finance-circulars/2005/docs/Cost_Recovery_Guidelines.pdf

[3] Guidelines – page 40

[4] Page 45

Accordingly, in order to manage the potentially negative impact of HFT on the market, the research found that in any recalibration of the cost recovery arrangements, a greater weighting to messages (rather than trades) should be forthcoming:

> They were also clearly in favour of a tax or cost imposed on messages if the message to trade ratio was too high. An across-the-board cost, applied independently of message source or message volume, was considered too blunt a weapon by most interviewees…
>
> There was no consensus on the actual size or threshold of the message tax; only that it had to act as a deterrent. One respondent likened it to a tax on spam emails – if excessive emails from a single source had a tiny fixed cost, it would have the impact of shutting down very low margin spam operations fairly quickly, and the same would apply to low margin HFT operations.[5]

However in order to be consistent with the guiding principle, any recalibration of the cost recovery arrangements should only occur where there is a measurable cost associated with a regulatory activity.

In this case, there would need to be a higher cost of supervision occurring because of a higher message to trade ratio (HFT).

As the industry does not have a detailed breakdown of the regulatory supervision costs associated with a single message or a single trade, we can not make an assessment independently of ASIC-provided cost information.

ASIC has consistently reported an increased regulatory cost in monitoring the rise in algorithmic trading which has increased trading volume, cancelled orders and messages for each transaction.

As noted in the discussion paper:

> However, since the current fee model was designed there has been a significant increase in the amount of time spent by ASIC's staff working on issues related to increased algorithmic trading including HFT.
>
> Specifically:
>
> • a substantial increase in algorithmic trading including HFT — incorporating not only increased trading volume, but increased cancelled orders and messages for each transaction executed — has led to a general increase in ASIC's workload:
>
> – HFT now accounts for 25-30 per cent of all lit market transactions, and the high order-to-trade nature of HFT means it accounts for a substantially higher share of orders and messages than more traditional trading strategies do;
>
> • more brokers support HFT clients, adding to ASIC's work on certification and dealing with issues arising from varying degrees of brokers' experience in this field;
>
> • an increase in HFT-related issues arising which then flow through to ASIC's market integrity deterrence teams; and
>
> • an increasing need for further analysis into the impact of HFT on market integrity and efficiency and potential policy responses. [6]

Accordingly we are supportive of the proposals to recalibrate the market supervision cost recovery arrangements to better reflect the cost of supervision. This should occur through the creation of a message based fee which is imposed on all participants.

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[5] Page 17
[6] Page 12

4. *Specific questions*

Messages

Do you consider that the cost recovery arrangement for equities market supervision costs (for ASX listed securities) should be amended so that some non-IT costs should be recovered through fees on messages? If not, please explain your preferred alternative.

Cost recovery should cover both IT costs and the appropriate cost of analysis of the impact to market quality and integrity of message traffic.

As stated we believe the cost recovery arrangements should incorporate a cost on messages in addition to the existing cost on trades.

Market making

Do you consider that the cost recovery arrangements for equities market supervision costs (for ASX listed securities) should be amended so that beneficial market making activity (subject to strict eligibility criteria) is subject to a reduced cost recovery levy for message based charges? If not, is there an alternative method to prevent the cost recovery arrangements creating a disincentive to undertaking beneficial market making activity?

We believe great care needs to be taken in considering any exemption. The principle must be that the only exemption available should be for genuine liquidity in a market making context. It should not be extended to 'illusory' market makers.

Market makers already have an advantage by being able to quote two sided spreads and if the market increases in toxicity over a period, the market maker has the option to either not participate or widen spreads which is consistent with the theory on the topic.

There is a paucity of evidence that proves that a high message to trade ratio improves markets, and a mounting credible body of evidence that shows it is detrimental.

The case for exemptions may be made where market makers are obligated to display a minimum quote (and trade) size with a trade cancellation cap that is reasonable, monitored, publicised and enforced.