16 December 2016

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

Email: asicfunding@treasury.gov.au

Dear Minister

Proposed Industry Funding Model for the Australian Securities and Investments Commission Proposals Paper

Governance Institute of Australia (Governance Institute) is the only independent professional association with a sole focus on whole-of-organisation governance. Our education, support and networking opportunities for directors, company secretaries, governance professionals and risk managers are unrivalled.

Our members have primary responsibility to develop and implement governance frameworks in public listed, unlisted and private companies. Our members, due to their involvement in governance and corporate administration, have a thorough working knowledge of the Corporations Act, and liaise with the Australian Securities and Investments Commission (ASIC) regularly in the course of their work. In listed companies, they have primary responsibility to deal with the Australian Securities Exchange (ASX) and interpret and implement the Listing Rules. Our members have a thorough working knowledge of the operations of the markets and the needs of investors.

Governance Institute welcomes the opportunity to comment on the *Proposals Paper: Proposed Industry Funding Model for the Australian Securities and Investments Commission* (the paper) and draws upon the experience of our members in providing our response.

General comments

Governance Institute strongly supports the roles and responsibilities of ASIC in maintaining and facilitating the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs, and the efficiency and development of the economy; and promoting the confident and informed participation of investors and consumers in the financial system. Our members recognise that ASIC's role is central to maintaining trust and confidence in the market, which funds the broader Australian economy. We also recognise that a well-funded regulator is vital and that there must be proper accountability and transparency in relation to any funding it receives.

Our members agree in principle with the Australian Government's decision to adopt the Financial System Inquiry recommendation that public funding of ASIC should be supported by an industry-funding model. Governance Institute recognises that the price of having an efficient market with integrity is to ensure that the regulator has sufficient funding, and is of the view that joint government and industry funding is the right model. We also note the precedents for an industry-funding model, such as AUSTRAC in Australia and the Financial Conduct Authority in the United Kingdom.

We are also of the view that the proposals paper sets out a model for the funding of ASIC by industry that is fairer and more proportional than the one set out in the earlier consultation paper. We commend the Treasury for taking into account stakeholder feedback and working with stakeholders to develop a model that is taking shape as one that can be supported.

Notwithstanding our in-principle support for an industry-funding model and our views that the proposals paper sets out a more viable model, our members have genuine concerns over aspects of the model, which we set out in more detail below. We are of the view that these matters need addressing for the proposal model to be fully supported by stakeholders. We also acknowledge that Treasury has held roundtables with participants at which some of these issues were discussed, which hopefully assisted in clarifying the concerns we hold.

Yours sincerely

Steven Burrell
Chief Executive

Detailed comments

Impact on listed entities

Our prime concern is the impact of the proposed funding model on listed entities. Our concerns are as follows:

- The proposed model is not proportional and aligned to expected need for regulatory oversight and activity, but is predicated on size and financial capacity.
- Unintended consequences flow from having no risk weighting attached to the market capitalisation metric, the main one of which is that well-run and governed listed entities that have very little interaction with ASIC and require no regulatory effort face significant levies based purely on size and financial capacity.
- The policy underlying the funding model should encourage good conduct and governance and send a pricing signal to entities about their value, and act as a deterrence to poor conduct and governance. If companies are well-run and treat their shareholders and customers fairly, they are behaving as good corporate citizens and will have very little interaction with the regulator. The proposed model should not result in well-run entities subsidising badly behaved entities. A different approach to how enforcement costs are spread across the sector is needed.

Proposed model

One of the design objectives of the proposed model is that it be proportional, that is, that levies for each sector should align to expected need for regulatory oversight, including the level of anticipated consumer or investor exposure.

The proposals paper states that (page 11):

> the market capitalisation of public listed companies is the metric judged to reflect the quantum of potential investor harm from any misconduct, as well as the rising cost and complexity of regulation with increasing company size.

The supporting attachments to the proposal paper also state that (page 21):

> 60. Market capitalisation has been proposed as a proxy for ASIC's supervisory intensity because the intensity of ASIC's regulation varies depending on the scale of the company's operation. Larger entities generally pose a higher risk to the Australian economy as the number of investors and the entity's significance to the market are large.

The proposed model has a graduated levy that incorporates a minimum levy rather than the previously proposed tiering approach for most industry sectors. This change spreads levy costs across a sector, with the intent of more equitably spreading costs between small and larger entities and preventing potentially large threshold shifts in levy costs for small changes in business activities.

While the minimum levy for the corporate subsector recovers ASIC's actual direct and indirect costs that are considered stable from undertaking the activities of stakeholder engagement, policy advice, guidance, education and for a portion of ASIC's capital allowance, the graduated (variable) component of the levy for listed entities recovers ASIC's remaining costs using market capitalisation as the industry metric.

The proposals paper states that (page 12):

> It is proposed that a maximum levy cap would be applied to the levy for publicly listed companies. This recognises that the regulatory effort does not increase indefinitely with size in this sector. The benefit derived from participating in a market would

> continue to increase with scale but this would be counterbalanced by a proportionally reduced need for additional regulatory resources.

The proposals paper also states (page 22) that:

> where possible introduce an activity-based metric to distribute the costs within a sector. Each entity's regulatory costs to be calculated based on the entities' level of activity compared with others in the sector. The activity measure is selected to reflect the typical cost of regulating each entity.

Absence of risk weighting

We recognise that the proposal paper notes on page 23 in Table 2 that stakeholder feedback indicated a preference for a risk weighted levy, but that Treasury has decided that there will be no change to the model to accommodate risk weighting because:

> Calculating more detailed risk weighted levies requires considerable administrative burden for industry and ASIC. It would mean forming a judgement about the risks posed by each regulated entity in a population of approximately 40,000. Given the breadth of ASIC's regulatory activity it is considered that appropriate business activity metrics are a valid approximation for the regulatory burden across the regulated population.

At the roundtable, Treasury noted that while risk weighting is conceptually attractive, it was discarded as it would require ASIC to risk rate entities in order to calculate individual bills and that this would in itself increase compliance costs and industry funding levels, due to the additional workload for ASIC.

However, without some form of risk weighting attached to the market capitalisation metric, the proposed model cannot be said to align with its own design objective of being proportional. Treasury is in fact making a risk assessment based on size only when it comes to listed entities, as it states that larger entities generally pose a higher risk to the Australian economy as the number of investors and the entity's significance to the market are large. While the collapse of a large listed entity would have a market impact, no data has been provided as to the rate of regulatory intervention with large listed entities as opposed to smaller or non-listed entities.

We provide the following examples:

- Feedback from our members is that some listed entities with high market capitalisation will sustain an increase of more than 22 times in fees, irrespective of whether they require any regulatory focus or dedicated regulatory activity.
- A listed entity with an Australian Financial Services License (AFSL) and market capitalisation of approximately $2 billion will incur a levy of up to $80,000 in its first year compared to current fees of up to $3,000. The entity has a long history of being well governed and attentive to its members' rights and expectations. On average, the entity receives one member complaint per annum, always minor in nature, and always quickly resolved by the entity without ASIC intervention. Other than payment of annual statement fees, lodgement of annual accounts, and occasional change of a responsible manager or key person, neither this entity nor its members have any other interactions with ASIC (or FOS). A market capitalisation-based levy imposes a significant impost on its members through reduced returns, and fails to take into account the fact that its members have consciously selected a low risk, well governed investment in exchange for a reasonable and safe return, rather than risk their money and peace of mind in poorly governed, high-risk entities with irregular business models where member disappointment and ASIC involvement are normally at their highest.

We accept that Treasury has considered other metrics apart from market capitalisation, such as customer complaints and breach reporting, but that neither were considered workable across the subsector. We also recognise that Treasury has noted that industry participants need to recommend a second metric. Our recommended second metric is risk weighting, based on the *substantiated* need in the past for regulatory intervention and focus from ASIC. We also recognise this would require ASIC to change its business model.

We also note that the Australian Tax Office (ATO) risk rates all corporate groups. That rating then drives the type of audit activity and how entities need to interact with ATO. While we recognise that ASIC's scope is much broader than that of the ATO, it is important to note that there are Australian regulators successfully applying risk ratings.

To reiterate our concerns, as the proposed model is not risk-adjusted for the profile of the company (for example the complexity of the entity's business model and whether it has effective governance, risk and compliance cultures and frameworks, all of which strongly influence the need for regulatory oversight and intervention), the proposed model cannot be said to be proportional. Under the proposed model, those entities with simpler business models and effective cultures and frameworks will require less oversight and intervention and will effectively subsidise those industry subsector participants who do not have such governance and compliance frameworks in place.

Encouraging good conduct and governance

The proposed model has removed the minimum level of levy set out in the 2015 proposed model, but the variable level of levy has increased.

While we recognise and accept that ASIC's regulatory activities are spread across the entire subsector in relation to stakeholder engagement, policy advice, guidance and education and that industry funding also needs to accommodate a portion of ASIC's capital allowance, the proposed model clearly shows that more than half the costs relate to enforcement activities. Enforcement occurs when companies do not behave well.

Governance Institute strongly believes that the funding model should make a direct economic link between regulatory activity or effort and levies incurred. The policy underlying the funding model should encourage good conduct and governance — this is nudge theory. The funding model should send a pricing signal to entities about the value of good conduct and governance and act as a deterrence to poor conduct and governance. If companies are well-run and treat their shareholders and customers fairly, they are behaving as good corporate citizens and will have very little interaction with the regulator. An entity should save money by behaving well, rather than having its levy based purely on its size and financial capacity.

The reality is that listed entities tend to have one-off issues. While we recognise the argument that large listed entities that do not behave well can have a larger impact on investors and customers, it is also clear that the proposed model is not proportional but spreads the costs across the subsector, so that well-run entities subsidise badly behaved entities.

Governance Institute does not support all sector participants sharing the cost of enforcement. This model only serves to relieve offending entities of a cost at the expense of good corporate citizens. Those entities that comply with the regulations have already borne costs on people and processes in order to adhere to the law, and this model effectively requires them to compensate offending entities, which adds costs to complying entities with good governance frameworks and cultures. A fairer model — and one that would send an appropriate signal to the industry — would be to recover enforcement costs with larger financial penalties.

This accords with our earlier recommendation that risk weightings be attached to entities. The unfairness of the current proposed model would be ameliorated by spreading the costs to those entities that generate more regulatory activity. That is, entities that do not behave well and require regulatory focus will pay more than those that behave well and do not require regulatory intervention.

For example, we are of the view that the model could incorporate a loading factor for those entities that have been the subject of *substantiated* regulatory action in the previous three years. We note, for example, that insurance premiums increase for those entities that have had significant claims raised. Such a model could possibly carry non-linear escalation if the entity had more than one regulatory intervention in a year or repeated (but different) regulatory actions over some years.

We are of the view that a different approach to how enforcement costs are spread across the sector needs consideration, so that the industry funding model is indeed proportional.

Duplication of fees

Treasury's model is not aimed at regulating entities as a whole but rather individual components of an entity's business, notwithstanding the level of interaction by the entity with the regulator.

Listed entities will not only have a market capitalisation levy but other levies depending on whether they carry an AFSL, or are a credit provider, deposit taker or a responsible entity.

Below are some examples of how this will operate:

- A listed entity that is an investment management business has a market cap of $4 billion. Its expected levy is $137,621. Its current ASIC fees are $13,000 per annum. However, as well as being a listed entity, it will pay:
    - non-listed, disclosing public companies — $3,350
    - responsible entities — $269,380
    - wholesale trustees — $8,000
    - financial advice (general) — $920

  Total — $419,276
- In the case of listed stapled Australian real estate investment trusts (REITs), the entity will incur a levy based on market capitalisation. As REITs also have responsible entities, they will incur responsible entity fees as well as a funds under management (FUM) levy. FUM is defined as total gross assets of a registered scheme. In the listed REIT sector, FUM is a proxy for market capitalisation, and as a consequence, members in this industry consider that fees are being levied twice. Being a responsible entity is not necessarily indicative of higher ASIC oversight. As a result of the various fee levies, feedback from members indicate that increases of between 50 – 120 times in current fees will be incurred.

We also note that listed entities already pay significant fees to the Australian Securities Exchange (ASX) — listing fees. The proposed model means that listed entities will now pay two sets of fees in relation to oversight of their compliance with the Corporations Act, the ASX Listing Rules (which interact with the Corporations Act) and good governance obligations.

We note that the proposed model does not propose any offset by way of reduced listing fees for listed entities, despite the fact that ASIC now conducts market surveillance and has oversight of ASX compliance as well as other matters. We are of the view that such an offset should be considered.

Recommendations

Governance Institute recognises that the challenge of complexity versus simplicity is as great as the challenge of efficiency versus equity. Our recommendations seek to achieve a balance.

We recommend the following:

- Attach the second metric of risk weighting to market capitalisation to ensure the model is proportional and not based purely on size and financial capacity.
- Move from the subsector approach to a broader approach.
- A smaller flat rate for surveillance, which is a cost spread across the listed entity subsector, with enforcement costs recovered as larger financial penalties by incorporating a loading factor for those entities that have been the subject of *substantiated* regulatory action in the previous three years.

User-initiated service costs

We support the delay in order to refine the model for the revised fees-for-service proposal, as Governance Institute would not be able to support any framework that stifled innovation. We agree, for example, that the originally proposed $21,000 fee for novel relief applications considerably increases the costs for first movers bringing new products to market that may require ASIC regulatory relief.

Our support for the delay is predicated on an assumption that further consultation will be conducted on this issue. We strongly believe further consultation will be required, as the fees in that schedule involve increases of many multiples on current levels.

Questions

We have not responded to the questions set out in the consultation paper, apart from the question set out below.

What is the estimated total labour cost of these activities?

The response to this question will be dependent on the circumstances of each entity. We note that the costs are generally based on activities that the entity undertakes in order to fulfil its compliance obligations in relation to ASIC and should not be difficult to estimate. Importantly, these costs need to be calculated so that entities can include them in their budgets for the relevant financial period.