

# New levy risks pushing traders into the shadows

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A decision by the federal government to slug the stockbroking industry with a \$22.8 million cost recovery levy for the industry's supervision from January 1, could push the risks of share trading into more opaque and less regulated areas and is believed to have prompted at least one broker to consider becoming shadow brokers.

The levy, paid by market participants and operators to the corporate regulator, the Australian Securities and Investments Commission, to take over the supervisory powers of the ASX in August 2010, looks a lot like the controversial financial transactions tax that's been hotly contested in Europe and rejected in the US on the basis it could do more harm than good.

Before Christmas, ASIC sent market operators, or brokers, an invoice for what it is likely to charge each of them in 2012 for market supervision.

The cost charged to each broking house differs depending on the size, type of services offered and the volume of trades and messages.

Since then, a number of brokers have got together to organise a meeting early in the new year with Treasury to discuss the method of pricing as the burden the new impost will have on an industry that is struggling with low activity, rising regulatory costs and competition.

Some of the smaller, traditional brokers were told they would pay an estimated \$40,000 to \$60,000, while some of the bigger broking houses doing high frequency trading could pay more than \$1.5 million.

Given the tough conditions in broker land, this added cost and red tape could push some over the edge or send a few more into shadow broking which is less regulated and is where most of the recent blow ups occurred, including Sonray, Chartwell Enterprises, Lift Capital and Storr.

And while the stockbroking industry and the exchanges including Chi-X knew the levy was coming - and argued vigorously against it - many were shocked when ASIC sent them an email before Christmas giving a breakdown of the calculation, including how much they would be paying for ping-pong messages, which is the technical term for standing in the market without necessarily executing a trade.

For market makers and high frequency traders, who rely heavily on messaging, the new tax will make their business model a lot more expensive. In at least one case, it will push a broker into the red.

The unintended consequence of the tax is it could push more traders into dark pools, where they can escape the cost. Dark pools refer to trades between large institutions that are not conducted through a public market, so shares trade without open price disclosure.

Chi-X, which recently set up an alternative exchange in Australia, described the cost recovery fees on a message basis as "profoundly wrong."

"Imposing a message based fee without a thorough analysis, risks creating disincentives for liquidity providers to trade on Australia's licensed markets and would be contrary to policy aims of establishing Australia as a financial hub," it added.

The notion of introducing a transaction tax in the US was recently shot down by President Barack Obama after the Congressional Budget Committee warned if such a tax was imposed unilaterally in the US, trading would migrate overseas to whichever markets didn't end up imposing such a tax.

After all, in a world of instantaneous electronic trading, buyers and sellers will immediately transfer their activity to the venue with the lowest costs of buying and selling.

While the government and ASIC will deny the cost recovery levy is a financial transactions tax, many in the industry would argue otherwise. They are concerned that this is the thin edge of the wedge and will add to market uncertainty.

There is already a trend for advisers to migrate to the lesser regulated, indirect, or shadow broker space. As these entities are not market makers they escape ASX regulation, the ASIC market integrity rules do not apply, nor do the same level of liquidity requirements.

ASX market participants must calculate their liquid capital daily and report it monthly to the ASX. If minimum liquid capital falls below certain levels, the reporting requirement becomes daily.

All it takes to become a shadow broker is an Australian Financial Services Licence. The test for AFS licensing is "good fame and character or a questionable background is not enough for ASIC to refuse.

It means anyone who wants to set up shop either applies to ASIC for an AFSL or applies to be a representative of an AFSL holder.

This is how Sonray co-founder Russell Johnson's RJ Capital became an authorised rep last year, even after he'd had his passport seized by the Supreme Court of Victoria in a hearing that he used between \$100,000 and \$525,000 of funds belonging to Sonray clients to pay personal expenses. He faces 24 theft, conspiracy and dishonesty charges.

As market participants shrink in number, shadow brokers proliferate. The Gillard government might have given with one hand more competition in the broking sector by allowing a new exchange to set up, but it has taken away with the other with the latest set of costs.

Let's hope the impost doesn't turn more traditional brokers to shadow broking as well as to dark pools to reduce costs. In both cases the road is a long way to catch up.

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