Stockbrokers And Financial Advisers Association Limited

27 June, 2017

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Financial System Division
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The Treasury
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SUPPLEMENTARY ISSUES PAPER MAY 2017 – LAST RESORT COMPENSATION SCHEME

We refer to the Supplementary Issues Paper of May 2017 ("the Issues Paper") released by the EDR Review Panel consulting on the establishment, merits and potential design of a compensation scheme of last resort and for redress of past disputes (a "last resort compensation scheme" or "LRCS").

The Stockbrokers and Financial Advisers Association ("SAFAA") appreciates the opportunity to provide the comments set out below in relation to the questions raised in the Issues Paper dealing with the potential for a LRCS.

Preliminary Comments

SAFAA agrees that it is not in the interests of a fair and reputable market if retail investors who have been properly awarded to them by an appropriate body for losses they have suffered as a consequence of a breach by the financial service provider's obligations, are not able to have that compensation paid. SAFAA is supportive of moves

to strengthen the regulatory framework to ensure that investors are not denied the benefit of such an award.

It does not follow, however, that there should be an immediate adoption of a last resort compensation scheme if there are other more straightforward steps that could be taken to strengthen the existing regulatory framework that would not be as expensive as a LRCS.

It is critical to establish from the outset what is meant by a last resort compensation scheme. Is it to be a scheme limited to covering unpaid awards made by an EDR body or by a Court or other tribunal, or is it to be a broader compensation scheme to cover investment losses? SAFAA's response depends on the answer to this fundamental question. If there is to be a LRCS, it should be limited to the former. In SAFAA's view, the latter should not be regarded as a LRCS, but something significantly more.

A general compensation scheme would be far too costly and would raise the question of moral hazard, so on policy grounds, we would expect that it should not be supported.

The LRCS being proposed should not operate in relation to services provided by a Market Participant of an Exchange. The Market Integrity Rules and capital adequacy requirements, backed by the National Guarantee Fund (NGF), provide a high level of standards and investor protection which is not equaled in any other sector of the financial services industry. There have been few awards of compensation against stockbrokers, and no history of the awards not being paid. Capital requirements on Market Participants are such that non-payment is not a significant risk.

Complying with the LRCS framework would come at a significant financial cost to Market Participants, and there is no reason for this additional layer of regulation and cost to be imposed on Market Participants.

SAFAA's comments below in relation to the specific questions should be read subject to this basic position that the LRCS should not apply in relation to the stockbroking sector.

Section 1 – Scope and Principles

1. Is the Panel's approach to the scope of these issues appropriate? Are there any additional issues that should be considered?
2. Do you agree with the way in which the Panel has defined the principles outlined in the Review's Terms of Reference? Are there other principles that should be considered?

SAFAA notes that the Terms of Reference of the EDR Panel have been amended by the Government, and that the Panel has released the Issues Paper in line with these.

In SAFAA's submission, the consideration of the LRCS is a matter of putting the cart before the horse. The correct approach, in our view, would be to establish answers to the following:

1. If amounts awarded are not being paid, why is this happening? In which particular sectors is this occurring?

2. It is a requirement for an AFSL holder to have sufficient capital for their business. In view of this requirement, why is it that some AFSL holders have not been a position to pay the amount(s) of EDR awards that have been made

3. It is a requirement for an AFSL holder to have arrangements in place for compensating retail clients for loss suffered for breach of relevant obligations. In view of this requirement, why is it that some AFSL holders have been unable to pay the amount(s) of EDR awards that have been made

4. It is a requirement for an AFSL holder to have adequate Professional Indemnity (PI) Insurance in place for their business. Why have awards not been paid, having regard to the PI Insurance cover that the Licensee had in place.

5. If there has been a failure to ensure compliance with the AFSL requirements referred to above, why has this been allowed to occur? Why has ASIC supervision of AFSL requirements not been able to deal with this issue(s).

In SAFAA's view, the approach inherent in the present exercise is to accept that there are no other solutions, and to proceed directly to deal with the symptoms. In our submissions, the approach should be to look at the underlying problems and deal with those first, rather than rush to introduce yet another regulatory cost into the system.

For example, we note the problems that have been identified by the EDR Panel relating to the value of PI insurance as a compensation mechanism – see p14 of the Issues Paper. The approach should be to first see how these shortcomings could be remedied.

SAFAA also notes that large numbers of AFSL holders have expended considerable amounts on regulatory compliance and on adequate financial soundness. Those entities, and whole sectors, have not created the problem that the proposed LRCS is designed to fix. However, they will be caught up in the solution, including the cost of paying for it, which will impact on them financially, and also on the cost of the services they provide to retail clients.

Section 2 – Existing compensation arrangements

3. What are the strengths and weaknesses of the existing compensation arrangements contained in the *Corporations Act 2001* and *National Consumer Credit Protection Act 2009*?
4. What are the strengths and weaknesses of the National Guarantee Fund, the Financial Claims Scheme and Part 23 of the *Superannuation Industry (Supervision) Act 1993*?
5. Are there other examples of compensation schemes of last resort that the Panel should be considering?

SAFAA limits its comments to the National Guarantee Fund ("NGF"). The NGF was established under legislation to protect investors by prescribing specific heads of claim to ensure that investors could trade on the ASX with confidence.

It was never intended as a general scheme for compensating for losses generally, nor was it ever funded to achieve coverage for broader classes of claims.

The NGF has been funded prospectively by amounts combined from the previous stock exchange fidelity funds. However, it is not funded on an ongoing basis, hence the amount in the NGF is entirely dependent on the claims history and on the earnings of the Fund. In a low return environment, the ability to grow the amount standing in the Fund, or to replenish the Fund for amounts paid out to claimants, is limited.

The NGF is backed by Market Participants and by the ASX (and any other exchanges who may become members), who are liable to pay a call made by the SEGC in the event that the SEGC determines that the amount of the NGF has fallen below the minimum amount.

This is not an ideal way of funding such a fund, as it amounts to funding on a "crisis" basis. It is impossible for Market Participants to properly provision for such a call, when the likelihood is that the events giving rise to a call will be unforeseen. The Market Participant is obliged to pay the amount of a call, and must meet it from its own funds, unless it is able to attempt to recoup the amount from customers by changes to pricing.

A call, if it were of significant size, could present serious financial problems for a firm, particularly a small to medium-size firm. There is also a potential anti-competitive effect, as larger firms could absorb a call in order to take market share from smaller firms who, being less able to do so, may need to pass the cost on to clients by way of higher charges.

Levying the cost of the Fund by a call on members results in firms who are compliant and solvent paying the costs of those firms who are not.

The NGF arrangements are also totally reliant on ASIC and the Exchanges supervising the capital adequacy of all Market Participants to ensure that a default does not occur.

Section 3 – Evaluation of a compensation scheme of last resort

6. What are the benefits and costs of establishing a compensation scheme of last resort?
7. Are there any impediments in the existing regulatory framework to the introduction of a compensation scheme of last resort?
8. What potential impact would a compensation scheme of last resort have on consumer behaviour in selecting a financial firm or making decisions about financial products?
9. What potential impact would a compensation scheme of last resort have on the operations of financial firms?
10. Would the introduction of a compensation scheme of last resort impact on competition in the financial services industry? Would it favour one part of the industry over another?
11. What flow-on implications might be associated with the introduction of a compensation scheme of last resort? How could these be addressed to ensure effective outcomes for users?
12. What other mechanisms are available to deal with uncompensated consumer losses?
13. What relevant changes have occurred since the release of Richard St. John's report, *Compensation arrangements for consumers of financial services*?

As mentioned above, the approach to these questions depends on the answer to the fundamental threshold question, namely, is the LRCS to be a fund only for unpaid awards resulting from insolvency of the licensee, or a broader compensation scheme.

The questions also depend on who is paying for the LRCS.

It is all well and good to introduce a LRCS, but it needs to be paid for. In SAFAA's view, the cost of administering and running a LRCS, and the cost of raising the funds for the scheme, are critical issues.

If the Government wishes to pay for a LRCS out of public funds, then this is a decision for the Government. Similarly, if the cost of the LRCS is to be levied on individual investors, being the beneficiaries of the LRCS, then that is also a matter for the Government.

However, there is a residual question of moral hazard, which has been identified both in the Issues Paper and in the St John Report. If the LRCS is a general compensation scheme for investors, then it will provide protection for people who choose to deal with bad advisers, and /or who chase unrealistic rewards. This would be contrary to the key thrust of Government policy, which is supposed to be geared to encouraging investors to deal with professional advisers and seek quality advice. A broader LRCS will allow investors people to go to poor quality advisers with the knowledge that, if all goes bad, there is an avenue for them to try to get their money back.

For these reasons, SAFAA's view is that any LRCS must be limited to a true scheme of last resort, and only serve to make good any awards that are appropriately made by an EDR scheme or Court and which are not paid.

The impact of the cost of a LRCS will depend on who is required to bear it. As mentioned earlier, SAFAA supports the cost being levied on investors, if it is not to be met by the Government from consolidated revenue. The LRCS would effectively be an insurance scheme, the beneficiaries of which are investors, and therefore the cost should be recouped directly from them.

The situation may vary from sector to sector within financial services, however in relation to stockbroking, it is the direct experience of SAFAA members that levying the charge on AFS Licensees and relying on them to recoup the cost from clients is a model that has been a catastrophic failure.

This model prevails in relation to ASIC Market Supervision cost recovery. Competition in the stockbroking sector has been so intense that firms have been unable to pass the cost through. Rather, the cost has been met by reducing staff and investment in businesses.

We note our initial argument that circumstances justify a LRCS not to apply to Exchange Market Participants. However if it is to apply, then funding it by a levy on Market Participants will be just one more layer of cost that will be borne by Participants and unlikely to be passed through to the beneficiaries of the LRCS, namely clients.

In relation to Question 13, there have not to our knowledge been any material changes since the release of the St John Report. We note the conclusions that are reproduced in the text box on page 21 of the Issues Paper. In our view, the recommendations of the St John Report remain valid today.

Section 4 – Potential design of a compensation scheme of last resort

14. What are the strengths and weaknesses of the ABA and FOS proposals?
15. What are the arguments for and against extending any compensation scheme of last resort beyond financial advice?
16. Who should be able to access any compensation scheme of last resort? Should this include small business?
17. What types of claims should be covered by any compensation scheme of last resort?
18. Should any compensation scheme of last resort only cover claims relating to unpaid EDR determinations or should it include court judgments and tribunal decisions?
19. What steps should consumers and small businesses be required to take before accessing any compensation scheme of last resort?
20. Where an individual has received an EDR determination in their favour, should any compensation scheme of last resort be able to independently review the EDR determination or should it simply accept the EDR scheme's determination of the merits of the dispute?
21. If a compensation scheme of last resort was established and it allowed individuals with a court judgment to access the scheme, what types of losses or costs (for example, legal costs) should they be able to recover?
22. Should litigation funders be able to recover from any compensation scheme of last resort, either directly or indirectly through their contracts with the class of claimants?
23. What compensation caps should apply to claims under any compensation scheme of last resort?
24. Who should fund any compensation scheme of last resort?
25. Where any compensation scheme of last resort is industry funded, how should the levies be designed?
26. Following the payment of compensation to an individual, what rights should a compensation scheme of last resort have against the firm who failed to pay the EDR determination?

We reiterate that the response to these questions depends on the scope of the LRCS and who is funding it.

In SAFAA's view, one would expect a LRCS to be available to meet an unpaid award of compensation from a Court or Tribunal of appropriate jurisdiction, as well as an award from an EDR scheme. It also makes sense for the LRCS to be able to make a payment in respect of any ancillary costs, such as legal costs, that were awarded by the Court or tribunal.

Subject to two qualifications, it does not make sense for the LRCS to assess independently a claim, where the award has been made by a Court or Tribunal in which the claim has been properly tested according to legal principles. This would be

duplication of effort and unnecessary cost. If the claim has been tested according to legal principles, then the unpaid damages should be eligible for payment.

The first qualification is that, where the decision of the Tribunal has not been based on a legal assessment of the claim, or where an award has been made by the Tribunal or the Court without the claim being contested (for example, the licensee may have already been insolvent, or may not have appeared to contest the matter for whatever reason), then the LRCS should be required to review independently the claim and assess it according to legal principles prior to making payment.

The second proviso is that a LRCS should be empowered to enquire into whether the investor engaged in excessively risky decision making in relation to the investment, such as "chasing returns" or seeking out poor quality advice. These matters may have been outside the factors that were relevant to the Court or Tribunal's determination of the claim, however they should be matters that the LRCS should be entitled to take into account in order to minimize the moral hazard risk inherent in a LRCS.

As regards the funding of the LRCS, and industry funding, we refer to our comments in the preceding Section 3.

27. What actions should ASIC take against a firm that fails to pay an EDR determination or its directors or officers?
28. Should any compensation scheme of last resort be administered by government or industry? What other administrative arrangements should apply?
29. Should time limits apply to any compensation scheme of last resort?
30. How should any compensation scheme of last resort interact with other compensation schemes?
31. Are there any aspects of compensation schemes of last resort in other sectors and jurisdictions that should be considered in the design of any compensation scheme of last resort?

A failure to pay an EDR determination should be, (and presumably would be), grounds to revoke the AFSL of the financial service provider. It should also be a basis for a banning order against any directors and officers who were party to the non-payment.

In relation to the directors and officers, banning should not automatically follow. Firms can fail for valid reasons, and there may be grounds why the failure, which led to the inability to pay an EDR determination, should not of itself constitute sufficient grounds for a banning order against individuals.

The National Guarantee Fund (NGF) should operate separately and distinctly from a LRCS. As we have previously argued, a LRCS should not be extended to the stockbroking sector. If contrary to our submission, an LRCS is adopted industry wide, then the LRCS and NGF should each operate according to their terms, save for a provision preventing an investor being entitled to recover twice in respect of loss should their claim happen to fall within the terms of both schemes.

Section 5 — Legacy unpaid EDR determinations

32. What existing mechanisms are available for individuals who have legacy unpaid EDR determinations to receive compensation?
33. Is there a need for an additional mechanism for those with legacy unpaid EDR determinations to receive compensation? If so, who should fund the payment of the legacy unpaid EDR determinations?

SAFAA would be opposed to a LRCS operating retrospectively, particularly in view of the need to fund the scheme prospectively.

If the Government wished, in the interests of justice, to open the LRCS to provide for legacy determinations, then it should consider doing so by extending the operation of the LRCS to existing unpaid determinations, but funding the payment of those legacy awards from consolidated revenue rather than from the funds in the LRCS.

Circumstances which have prevented access to redress

34. Other than circumstances that may be covered by a compensation scheme of last resort (such as outstanding unpaid determinations), what kinds of circumstances have given rise to past disputes for which there has not been redress? Are there any other classes besides those identified by the Panel?
35. What evidence is there about the extent to which lack of access to redress for past disputes is a major problem?

SAFAA notes that, because of the factors previously referred to, including the higher standards of regulation and capital adequacy requirements applying to Market Participants, and the existence of the NGF, there is no evidence of any unpaid compensation to clients of stockbrokers or any lack of access to redress.

Approaches to providing access to redress for past matters

36. Which features of other approaches established to resolve past disputes outside of the courts (whether initiated by industry or government) might provide useful models when considering options for providing access to redress for past disputes in the financial system?

Evaluation of providing access to redress for past disputes

37. What are the benefits and costs associated with providing access to redress for past disputes?
38. Are there any legal impediments to providing access to redress for past disputes?
39. What impact would providing access to redress for past disputes have on the operations of financial firms?

SAFAA does not comment in relation to the above questions.

Evaluation of providing access to redress for past disputes (continued)

40. What impact would providing access to redress for past disputes have on the professional indemnity insurance of financial firms?
41. Would there be any flow-on implications associated with providing access to redress for past disputes? How could these be addressed in order to ensure effective outcomes for users?

The response to this questions depends on the fundamental threshold question of the scope of a LRCS, and liabilities of the AFS Licensee under the scheme.

If, contrary to our submission, a LRCS is intended to operate as a more general compensation scheme for losses suffered by an investor, then redress of past disputes should not be available such that the scheme operates retrospectively.

The LRCS should not operate in a way that would open up liability of an AFS Licensee after a limitation period has expired, or after the Licensee's PI insurance policy coverage for past events has run off. If any liability could be attached to the Licensee under the LRCS, after its insurance cover had ceased under the terms of the policy, then this would be extremely unfair.

Design issues for providing access to redress for past disputes

42. What are the strengths and weaknesses of the Westpac proposal?
43. What range of parties should be provided with access to redress for past disputes? Should all of the circumstances described in paragraphs 133-144 be included?
44. What mechanism should be used to resolve the dispute and what criteria should be used to determine which disputes can be brought forward?
45. What time limits should apply?
46. Should any mechanism for dealing with past disputes be integrated into the new Australian Financial Complaints Authority (once established) or should it be

independent of that body?
47. Who should be responsible for funding redress for past disputes? Is there a role for an ex gratia payment scheme (that is, payment by the Government)?
48. Should there be any monetary limits? If so, should the monetary limits that apply be the EDR scheme monetary limits?
49. Should consumers and small businesses whose dispute falls within the new (higher) monetary limits of the proposed Australian Financial Complaints Authority but was outside the previous limits be able to apply to have their dispute considered? Should access to redress for past disputes be provided through a transition period whereby the higher monetary limits are applied for a defined period retrospectively? If so, what would be an appropriate transition period?
50. If it is not possible to fully compensate all claimants, should a 'rationing' mechanism be used to determine the amounts of compensation which are awarded? Should such mechanism be based on hardship or on some other measure?
51. Are there any other issues that would need to be considered in providing access to redress for past disputes?

The financial stability of the LRCS is a matter that requires careful planning and management. The fund should be prudently managed so that the amount in the fund can be grown through earnings. As mentioned, the fund should be managed prospectively, so that proper provisioning can be made by any parties liable to contribute to it.

As mentioned also, initial funding will be required to place the LRCS in funds at the outset. This should be provided by the Government, subject to appropriate provisions to allow for this initial payment to be recouped in later years from any excess funds, if that is what the Government chooses to do.

If payment of claims reduces the amount in the fund, the relevant financial sector in which those unpaid claims occurred should be liable for contributing to replenish the fund. This will encourage each sector of the finance industry to pursue professionalism amongst peers in that sector, and will act against cross subsidization of sectors that fail in their obligations by those sectors that meet them. SAFAA supports the UK model in this regard.

If the level of claims at any one time is such that there are insufficient funds in the LRCS to meet investor claims in full, then there would clearly need to be either some cap applied to apportion the available funds between claims, or some form of "top up" by the Government to allow for claims to be paid in full.

If industry is to be liable for funding the LRCS, then governance of the Fund is an essential issue. Industry must be represented on the Board of the LRCS so that they have a voice on matters such as the investment of the fund, issues relating to payout

decisions, and other issues relating to the preservation of the fund, including pursuing and/or defending claims that will have an impact on the amount of the fund.

CONCLUSION

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,

Andrew Green
Chief Executive

Stockbrokers
And Financial Advisers
Association Limited

4 July, 2017

EDR Review Secretariat
Financial System Division
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Dear Sir / Madam,

SUPPLEMENTARY ISSUES PAPER MAY 2017 – LAST RESORT COMPENSATION SCHEME FURTHER SUBMISSION

We refer to the Stockbrokers and Financial Advisers Association ("SAFAA") Submission dated 27 June 2017 lodged in relation to this subject.

We wish to make a Further Submission on one aspect of the Supplementary Issues Paper of May 2017 ("the Issues Paper") in order to clarify one aspect of our Submission.

Further Submission - Questions 34 – 51 - Section 5 Legacy unpaid EDR / Access to Redress for Past Disputes

In preparing our Submission, we have construed this part of the Issues Paper on the assumption that the proposals regarding a mechanism for Access to Redress for Past Disputes (ARPD) would be based on utilizing the Last Resort Compensation Scheme (LRCS) as the fund for any such payments.

On further analysis, we note that the Issues Paper could also be read as putting forward the proposal that there be a mechanism for ARPD that is separate and distinct from the creation of a LRCS.

In this Further Submission, SAFAA wishes to state in the strongest terms that, subject to knowing in more detail how such an ARPD mechanism would operate, SAFAA would be opposed in principle to any stand-alone ARPD mechanism that opened up liability for a Licensee well after the event. Such a proposal would potentially be so unfair as to be manifestly oppressive.

In making this Further Submission, we note:

1. The EDR Review Panel has previously recommended the merger of the existing three EDR schemes into one scheme, which recommendation has been adopted by the Government and has resulted in the announcement of the creation of AFCA. The principal justification put forward for this recommendation was that investors were confused by having different dispute resolution frameworks available to them. For the same reasons, we would not have thought that the EDR Review Panel would have been attracted to the idea of there being an ARPD scheme that operated on a stand-alone basis separate from the LRCS, and which could just as easily be thought of as confusing to investors.

2. At paragraphs 159-162, the Issues Paper itself sets out a number of likely impacts that an ARPD scheme would have, including:

    - Firms will have entered into contractual relationships with EDR schemes that specified the types of disputes that the scheme is able to consider, and firms rely on the terms of those arrangements in order to manage their affairs;
    - An ARPD scheme would have the effect of creating exposure beyond the terms of these arrangements and beyond that for which the firm had made proper provision;
    - The impact on professional indemnity insurance cover. Firms could become liable for events long after PI insurance cover had run off or provisioning had been held;
    - An ARPD scheme along these lines could have an impact on capital adequacy of prudentially regulated firms.

3. In SAFAA's submission, the above observations in the Issues Paper should be of such weight as to rule out a stand-alone ARPD scheme. A scheme that had these effects would make it impossible for a Licensee to take prudent steps to

undertake risk management or to properly manage its business. It would create a potential open-ended liability in perpetuity. This is precisely why the concept of statutes of limitations exists as a fundamental cornerstone of our legal system. SAFAA does not see how such an ARPD scheme could be proposed on such a basis in all fairness.

4. A stand-alone ARPD scheme could have the effect that the newly announced $1 million claims cap could be applied retrospectively to past disputes, long after the time in which the dispute occurred or the regulatory requirements governing those disputes, including the monetary limits applicable at the time, were in place, and long after insurance cover for such amounts could have been envisaged.

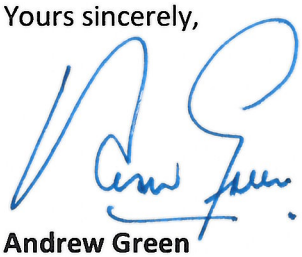
5. Investors have access to EDR arrangements that are comprehensive, and will soon be made even more so, having regard to announcements by the Government in relation to the EDR Review Panel's recommendations. Investors should avail themselves of that framework, or alternatively, the Court system, to bring a dispute.

6. Whilst it is one thing to make provision for a Last Resort Compensation Scheme in industry sectors where there has been a demonstrated need for it, in order to ensure investors who are awarded compensation receive payment, an ARPD SCHEME that gives rise to risk that is impossible to manage does not strike the correct regulatory balance between protecting investors and the rights of advice providers.

CONCLUSION

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,



Andrew Green
Chief Executive