

# Chapter 1: Introduction

This chapter outlines the scope of the review and the review process, and provides background.

## Terms of reference

1.1 The reviewer has been asked to consider the need for, and costs and benefits of, a statutory compensation scheme for financial services.

1.2 The review follows a recommendation by a Parliamentary Committee that the Government investigate the costs and benefits of a statutory compensation scheme.

1.3 The Parliamentary Joint Committee on Corporations and Financial Services (PJCCFS) conducted an *Inquiry into financial products and services in Australia* following a number of collapses in the financial sector which resulted in substantial financial losses and damage to a large number of investors. The Committee reported on its inquiry on 23 November 2009.

1.4 In regard to compensation arrangements for investors, the Committee referred to submissions it had received advocating the establishment of a statutory compensation scheme. It noted deficiencies in current arrangements which largely rely on professional indemnity insurance as a basis for compensation.

1.5 The Committee recognised that ‘deficiencies of (professional indemnity) insurance make a last resort statutory compensation fund covering licensee wrongdoing appealing’. The Committee recognised that more work would be required to overcome significant issues in design and to ensure that the cost on industry would be fair and equitable and justified by the protection offered to consumers.

1.6 Recommendation 10 of the Committee’s Report was:

...that the Government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.

1.7 In response to the Report, the Government announced the *Future of Financial Advice* reforms on 26 April 2010.<sup>1</sup> The response adopted most of the recommendations of the Report, including one for the examination of a statutory compensation scheme. The response also included some additional measures.

1.8 In relation to the Committee’s recommendation about compensation, the then Minister for Financial Services, Superannuation and Corporate Law, the Hon Chris Bowen MP, announced that Richard St. John had been engaged to undertake the review of the need for a statutory compensation scheme.

1.9 It is noted that, since the review was initiated, the collapse of Trio Capital has thrown up further issues about the ability of consumers to recover compensation

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1 The Hon Chris Bowen MP (Minister for Financial Services, Superannuation and Corporate Law), Media Release No 036/2010, 26 April 2010.

following the failure of a financial product due to fraud. The circumstances of that case are also the subject of an inquiry by the PJCCFS.

## **Background and scope**

1.10 The following concepts and issues are relevant to and bear on the review:

- The review is directed to the adequacy of arrangements by which investors may be compensated where they suffer loss as a result of misconduct by a provider of financial services. Those arrangements arise in the context of the regulatory regime for financial services and markets provided under Chapter 7 of the *Corporations Act 2001* (Corporations Act).
- Providers of financial services are required to be licensed under Chapter 7 and to have compensation arrangements in place in relation to their retail clients. The rationale for the focus on retail clients is that they are less likely to be able to look after their own interests than are wholesale clients.
- Licensed providers of financial services are subject to a range of obligations under Chapter 7. The review is concerned with the position of retail clients who incur a financial loss or damage as a result of a breach of such an obligation by a licensee or its representative.
- The review is concerned with the position of a retail client whose loss is attributable to the misconduct of a financial services licensee. It is not concerned with losses that result from failure of a financial product or poor investment performance in the absence of licensee misconduct.

## **Financial services**

1.11 A person who operates a financial services business is required under Chapter 7 of the Corporations Act to hold an Australian financial services licence and is referred to in this report as a licensee.

1.12 The financial services provided to clients by licensees generally relate to a financial product. The term 'financial service' includes, in relation to a financial product, providing advice, dealing, making a market, operating a registered managed investment scheme or providing a custodial or depository service. A 'financial product' includes a security, a derivative, an interest in a managed investment scheme, a superannuation interest, a general or life insurance policy, a deposit-taking facility or a margin lending facility.<sup>2</sup>

## **Financial services industry**

1.13 Almost 5,000 entities are licensed to offer one or more of the broad range of financial services described above. More than 4,500 licensees are authorised to provide advice, with almost 3,300 of those authorised to provide personal advice. More than 4,600 licensees are authorised to deal in a financial product, with almost 60 per cent of those licensees authorised to issue a financial product, including deposits, insurance, managed investment schemes, securities, superannuation

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2 Division 3 and 4, Chapter 7 *Corporations Act 2001*, with particular reference to section 764A.

products or margin lending. Table 1.1 provides more detail on the number of licensees authorised to undertake financial services.

1.14 Almost 93 per cent of licensees are licensed to undertake more than one financial services activity. More than 70 per cent of them are authorised both to provide financial product advice and to deal in a financial product.<sup>3</sup> Table 1.1 shows the number of licensees categorised according to the financial services activities they are authorised to undertake, whether a single or multiple activities.

**Table 1.1 Number of licensed financial service providers by activity**

Total number of licensees authorised by type of activity (a)	By sub-activity
<b>Provide financial product advice</b> (licensees authorised to provide personal, general or wholesale advice, whether for one financial product, such as margin lending or life insurance, or for multiple financial products). This includes:	4,562
Licensees authorised to provide personal advice(b)	3,294
Licensees authorised only to provide general or wholesale advice	1268
<b>Deal in a financial product</b> (licensees authorised to deal in financial products, including those applying for or acquiring a financial product, issuing a financial product, underwriting securities or interests in managed investments, varying a financial product or disposing of a financial product). This includes:	4,651
Licensees authorised to deal by issuing a financial product	2,731
Other licensees authorised to deal in a financial product	1,920
Make a market for a financial product	203
Operate a registered scheme	599
Provide custodial and depository service	637
<b>Total number of licensees authorised to undertake more than one activity</b>	<b>4,544</b>

(a) Licensees may be authorised to undertake more than one activity and thus the sum of the activity categories is more than the number of licensees.

(b) An authorisation to provide personal advice also allows the licensee to provide general or wholesale advice.

Source: ASIC data as at 31 December 2010.

1.15 The review is concerned with licensees who provide financial services to retail clients. Around three quarters of licensees, that is just under 3,700, are authorised to provide services to retail clients. Around 270 of those licensees, being deposit-takers or insurers, are also prudentially regulated by APRA and are not required to have professional indemnity insurance for compensation purposes.

1.16 Licensees may authorise representatives to carry out financial service activities for which they are authorised under their licence, and in so doing assume the responsibility that the representatives will conduct themselves in the manner required of a licensee.

1.17 A subcategory of the licensees who are authorised in broad terms to 'provide financial product advice' specialise in financial planning for their clients. ASIC estimates that there are '749 advisor groups operating over 8,000 practices and employing around 18,200 advisers'.<sup>4</sup> An advisor group is a financial advisory business or group of businesses which operate under a single licence. A group may have more than one practice and may use multiple trading names. Advisers can operate through their own licence, as authorised representatives, or as employees of a licensee or an authorised representative.

1.18 ASIC has characterised the financial advice industry as 'dominated by large dealer groups and financial institutions' with 'approximately 85 per cent of financial

<sup>3</sup> These licensees are authorised to undertake only the specific activities mentioned.

<sup>4</sup> ASIC, *Submission to the PJC Inquiry into financial products and services in Australia*, August 2009, pp 108-109, with information attributed to the Rainmaker Financial Planning Report, January 2009.

advisers ... associated with a product manufacturer'. ASIC added that 'most large financial planning firms (that is, dealer groups) are owned by diversified financial services groups that also include funds management entities (that is, product manufacturers)'.<sup>5</sup>

## Retail clients

1.19 The review is concerned with compensation arrangements for retail clients of financial services providers. Those compensation arrangements are part of a package of consumer protection measures under the Corporations Act in favour of retail clients. Retail clients can include small businesses as well as individuals.<sup>6</sup>

1.20 The focus on retail clients reflects the view that, generally speaking, those clients are in greater need of protection than are wholesale clients who should be better informed and better able to assess the risks involved in financial transactions.<sup>7</sup>

1.21 An exception to this approach is the National Guarantee Fund (NGF) which is not limited to retail clients of a stockbroker. A wholesale client of a stockbroker with a claim could recover compensation from the NGF.

1.22 The classification of superannuation funds, including a self managed superannuation fund (SMSF), as wholesale or retail clients is complex and is discussed further in Chapter 3.

1.23 It is also noted that separate consideration is being given within the *Future of Financial Advice* reform process to the appropriateness of the current tests by which a client is classified as retail or wholesale. The Treasury released an options paper on this issue and is considering submissions.<sup>8</sup> Any ensuing change in the retail client test would have implications for the coverage of compensation arrangements under Chapter 7 of the Corporations Act.

## Obligations on licensees

1.24 Licensees are required, as part of holding a licence, to comply with a range of disclosure and conduct obligations depending on the financial service they provide. Licensees are also required to have in place a system for the resolution of disputes with retail clients and arrangements to compensate such clients for loss or damage arising from a breach of their obligations under Chapter 7.

1.25 The review is directed to compensation arrangements relevant to a retail client who incurs loss or damage as a result of a breach of such an obligation by a licensee or its representative. Such loss or damage could be incurred for example where a licensee:

- misappropriates funds provided by a client for the purposes of investment;

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5 *ibid*, p 110.

6 A business is a small business if it employs fewer than 20 people or is a manufacturer employing fewer than 100 people. Additionally, certain financial products such as superannuation products are deemed to be provided to retail clients (section 761G and Chapter 7, Part 7.1, Division 2 of the *Corporations Regulations*).

7 *Financial Services Reform Bill 2001*, Explanatory Memorandum, para 2.27.

8 The Treasury, *Wholesale and Retail Clients - Future of Financial Advice Options Paper*, 24 January 2011.

- provides personal advice which was not appropriate to the client having regard to the adviser's inquiry into the client's personal circumstances and investigation of the subject matter of the advice;
- provides a product disclosure statement that does not make the required disclosures, for example on any significant risks of holding the product;
- engages in dishonest, misleading or deceptive conduct in relation to a financial product or service, or makes false or misleading statements that are likely to induce persons to acquire a financial product; or
- makes an unauthorised transfer of securities.

### **Financial loss in absence of misconduct**

1.26 Consistent with the fundamental regulatory approach, the review is not concerned with compensation for investors who suffer loss in value of their investment through:

- product failure or general investment losses;
- the financial failure of a financial product issuer; or
- performance by an investment that has not met expectations;

in the absence of inappropriate advice or other relevant misconduct by a licensee with whom they have dealt.

### **Review process**

1.27 The review has been carried out in two stages: research, information gathering and preliminary consultation that led to the release of a Consultation Paper; and the consultative and deliberative stage that followed. The reviewer was assisted by a secretariat in the Treasury.

#### **Initial information gathering**

1.28 The reviewer had preliminary meetings with interested parties in July 2010 and, following the election caretaker period, from October to December 2010. Those parties included the Insurance Council of Australia (ICA), Financial Planning Association (FPA), Association of Financial Advisers (AFA), BT Financial Group, Financial Services Council (FSC), Australian Securities Exchange (ASX), CHOICE and John Morgan, partner, Allens Arthur Robinson.

1.29 Meetings were also held with the Australian Securities and Investments Commission (ASIC), Financial Ombudsman Service (FOS) and Professional Financial Solutions Pty Ltd (PFS) the firm engaged by FOS to prepare its proposal for a last resort compensation scheme. The reviewer discussed technical issues with the Australian Government Actuary (AGA).

1.30 The initial meetings were followed by dialogue between the secretariat and various industry bodies, Australian Prudential Regulatory Authority (APRA), ASIC, FOS and AGA in order to amplify information and clarify technical issues.

## Consultation

1.31 A Consultation Paper was released for comment on 20 April 2011.<sup>9</sup> Submissions were sought by 1 June 2011 although several bodies sought and were given an extension to submit views after that date. A summary of the Consultation Paper is provided in Appendix A.

1.32 Following the release of the Consultation Paper, and before the receipt of formal submissions, the reviewer had further discussions with ICA, FSC, FPA, CHOICE, AFA and the National Insurance Brokers Association (NIBA). A meeting was also held with Dr June Smith who had earlier carried out academic research on the basis for consumer compensation.

1.33 The review received 28 submissions of which five were subject to a request for confidentiality.<sup>10</sup> The public submissions were received from:

- Consumer advocates - Joint consumer submission prepared for a number of consumer organisations including CHOICE.
- Investors - ACTek Superannuation Pty Ltd, ARP Unitholders Incorporated, RADE Provident Fund.
- Legal and accounting bodies - Deloitte, Law Council of Australia, Maurice Blackburn, Slater and Gordon.
- Industry bodies - ICA, Australian Bankers Association, Association of Superannuation Funds Australia, FPA, FSC, Liability Reform Steering Group, NIBA, National Information Centre on Retirement Investments, Stockbrokers Association of Australia.
- Research house - van Eyk.
- Licensees - Professional Investment Services, Hayden Financial Services, Bruce Keenan.
- Dispute resolution bodies - FOS, Superannuation Complaints Tribunal.

An overview of submissions received in response to the Consultation Paper is provided in Appendix B.

1.34 Following their submissions, the reviewer had further meetings with FPA, FSC and ICA. The reviewer also met representatives of Self-Managed Super Fund Professionals Association of Australia (SPAA) and received its views.

1.35 The reviewer had a series of meetings with ASIC including with the Chairman, Mr Greg Medcraft.

1.36 The reviewer also had several meetings with FOS including with the Chief Ombudsman, Mr Shane Tregillis and a meeting with Mr Peter Daly, the Chairman of Financial Services Compensation Scheme Pty Ltd (FSCS) - a FOS subsidiary established to promote a last resort compensation scheme, PFS and AGA.

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<sup>9</sup> Richard St. John, *Review of compensation arrangements for consumers of financial services*, April 2011, available at [futureofadvice.treasury.gov.au](http://futureofadvice.treasury.gov.au).

<sup>10</sup> Copies of all submissions made available for public release are available at [futureofadvice.treasury.gov.au](http://futureofadvice.treasury.gov.au).

1.37 In addition the reviewer has had discussions with officers of the Treasury.

1.38 In July 2011, the reviewer conducted a week-long series of meetings in London in relation to the comprehensive compensation arrangements in place in the United Kingdom. He was supported by the Minister-Counsellor (Economic), Australian High Commission. The reviewer attended meetings with regulators and officials from Her Majesty's Treasury, the Financial Services Authority, the Financial Ombudsman Service and the Financial Services Compensation Scheme, and with:

- Association of British Insurers (John Breckenridge and Joel Lewis);
- Institute of Financial Planning (Phil Billingham and Susan Jordan);
- Investment Management Association (Richard Saunders and Susan Wright);
- Nigel Boardman, Jan Putnis and Charles Randell, partners of the law firm Slaughter and May;
- WHICH, a consumer advocacy organisation (Doug Taylor, Gareth Shaw and Vera Cottrell);
- Professor David Jackman, The Ethical Space; and
- Professor Paul Davies, University of Oxford.

1.39 In preparing the report, the reviewer has continued to draw, through the secretariat, on the knowledge and expertise of various industry bodies, APRA, ASIC, FOS, PFS, and AGA.

### **Acknowledgements**

1.40 I acknowledge with appreciation the input and assistance of all those industry groups, consumers, regulators and other interested parties who have made submissions or have provided information, comments and assistance, some of them on a continuing and intensive basis. I include also the bodies and individuals consulted in the United Kingdom who were generous with their time and insights. Together they have illuminated the issues and filled out my understanding. I also express my thanks to the members of the Treasury secretariat for their support throughout.

