

Appendix C: Other financial sector compensation arrangements

C.1 Apart from the section 912B arrangements, separate statutory compensation arrangements are already in place covering significant segments of the financial services sector. These arrangements have developed over the years in a somewhat piecemeal fashion.

Compensation regime for financial markets

C.2 The Corporations Act regulates the operation of financial markets such as securities and futures markets. Under Chapter 7 a person licensed to operate a market is generally required to establish a compensation regime if its participants provide financial services for retail clients that involve the participants holding money or property on behalf of those clients.¹

C.3 The purpose of these compensation arrangements is to promote confidence for retail investors in the handling of money or property provided to intermediaries for investment purposes. When the NGF was established, it was hoped that it would instil confidence and encourage participation in the share market, given the low level of participation at that time.²

C.4 Providers of financial markets are required to comply with one of two compensation regimes established respectively in Part 7.5. Members of the Securities Exchange Guarantee Corporation (SEGC) must comply with the compensation arrangements in Division 4 of Part 7.5. Other providers of financial markets must comply with the compensation arrangements in Division 3 of Part 7.5 of the Corporations Act.

C.5 In addition to the requirement that market operators establish compensation arrangements, participants in those markets, such as stockbrokers and futures traders, are required to have the financial capacity to meet claims for compensation from their clients. Under ASX operating rules, participants are required to meet capital adequacy requirements and core liquid asset ratios. Stockbrokers and other participants are required to hold professional indemnity insurance against a breach of duty owed in a professional capacity, whether in contract or at law.³ Failure to meet the obligation to have insurance attracts a maximum penalty of \$100,000.

C.6 In practice it is understood that stockbrokers take out professional indemnity insurance that meets their dual obligations as financial service licensees and as participants in the securities market. The latter requirement is broader in respect to cover 'against a breach of duty the market participant owes in a professional capacity whether owed in contract or otherwise at law'. Another distinction is that the market participant must advise ASIC within 10 business days of the renewal of its insurance

1 Section 881A *Corporations Act 2001*.

2 *Australian Stock Exchange and National Guarantee Fund Bill 1987*, Hansard, second reading speech to the House of Representatives, 18 February 1987.

3 ASIC Market Integrity Rules (ASX Market) 2010, February 2011, rule 2.2.1.

policy, including the amount and nature of cover, and to advise ASIC immediately of any notification to its insurer of a claim.⁴ Failure to meet these obligations attracts a maximum penalty of \$20,000.

National Guarantee Fund

C.7 SEGC administers the NGF as the compensation regime for the ASX which currently is its only member.

C.8 NGF was established in 1987 from the amalgamation of state and territory fidelity funds following a long history of stock exchanges operating their own fidelity funds.⁵

C.9 The Financial Services Reform Bill 2001 found that the financial system regulation was piecemeal. The Bill proposed that the NGF be replaced by Part 7.5 Division 4 of the Corporations Act.

C.10 NGF provides compensation for clients who incur a loss in their dealings with stockbrokers on the ASX in the following circumstances:⁶

- where a stockbroker has failed to complete a sale or purchase of securities entered into on the ASX's equities and debt market and where those transactions are required to be reported to the ASX by the stockbroker (that is, a contract guarantee);
- where a stockbroker makes an unauthorised transfer of securities;
- where a stockbroker cancels or fails to cancel a certificate of title to quoted securities contrary to the operating rules of the Australian Securities Exchange Settlement and Transfer Corporation Pty Limited; and
- where a person has entrusted property to a stockbroker who subsequently becomes insolvent and cannot meet its obligations to that person.

C.11 In the first three of those circumstances, there is no cap on the amount that can be claimed under NGF. In respect to a loss arising from a stockbroker's insolvency, compensation is limited to 15 per cent of the minimum size of NGF — which is currently required to be a minimum of \$76 million.⁷

C.12 NGF in practice covers claims by wholesale as well as retail clients.

C.13 Compensation is not available from NGF:

- for a loss arising from investment decisions or from relying on investment advice given by a participant;

4 *ibid*, rules 2.2.3 and 2.2.4.

5 NGF was established by *the Australian Stock Exchange and National Guarantee Fund Act 1987*. The Sydney Stock Exchange established a fund in 1937, and funds were subsequently established by the Perth Stock Exchange in 1968, by the Melbourne Stock Exchange in 1970 and by the Brisbane Stock Exchange in 1971. The *Securities Industry Act 1980* required all stock exchanges to establish and keep a fidelity fund and required a contribution to the fund of at least \$500 from all members, with additional levies imposed if the fund became insufficient.

6 Corporations Regulations Part 7.5, Division 4, Subdivisions 4.3, 4.7, 4.8 and 4.9.

7 Section 889I *Corporations Act 2001*.

- for a loss if a participant fails to act on instructions to buy or sell;
- for money lent to a participant which has not been repaid;
- in respect of conduct by an entity other than the specific entity which is the participant; and
- in respect of alleged unauthorised withdrawal or misappropriation by the participant of money in a client's account or held on a client's behalf (unless covered by one of the four circumstances noted above).

C.14 SEGC may impose a levy on operators or participants in their market if the amount in NGF falls below the minimum prescribed. SEGC has not found it necessary to impose any levies to date given the availability of assets rolled over from the pre-existing funds and subsequent investment earnings. NGF had \$106.1 million in assets as at June 2011.

C.15 Where a retail client of a stockbroker is unable to receive compensation through NGF the client could still bring a claim under the broker's s912B compensation arrangements if the broker failed to meet its obligations under Chapter 7. An example might be where a client relied on a broker's investment advice and the broker did not have a reasonable basis for the advice provided.

Compensation regimes for other market operators

C.16 Market licensees who are not members of SEGC must obtain approval from the Minister for compensation arrangements to deal with losses in the following circumstances:⁸

- where a retail client gives money or other property to a participant in connection with a transaction covered by the operating rules of that market and there is a defalcation or fraudulent misuse of that money or property by the participant; or
- where the retail client gives the participant authority over the property and the participant fraudulently misuses that authority.

C.17 The market operator must have 'an adequate source of funds available to cover claims' which arise from the losses described above.⁹ Examples of arrangements that have been accepted include a fidelity fund, insurance arrangements, an irrevocable letter of credit or a combination of these.¹⁰ The following market licensees have established compensation arrangements:

- SIM Venture Securities Exchange and the National Stock Exchange of Australia;
- Asia Pacific Exchange (formerly the Australia Pacific Exchange) — which has a fidelity fund with minimum cover of \$750,000;
- IMB — which has an irrevocable undertaking by an ADI with minimum cover of \$1 million;
- Australian Securities Exchange Supplemental Compensation Fund;

⁸ Sections 881B, 882A and 885C *Corporations Act 2001* and Corporations Regulation 7.5.15.

⁹ Section 885H *Corporations Act 2001*.

¹⁰ Notes to section 885H *Corporations Act 2001*.

- Sydney Futures Exchange Fidelity Fund; and
- Chi-X Australia Pty Ltd, which has a minimum amount of cover of \$10 million comprising a fidelity fund of at least \$200,000 together with insurance arrangements and/or an irrevocable letter of credit.

Financial Claims Scheme for depositors and policyholders

C.18 Following an announcement in June 2008, the FCS was established in October 2008 to provide depositors of authorised deposit-taking institutions (ADIs) and general insurance policyholders with certainty and timely access to funds in the event of the failure of such a financial institution.¹¹ In December 2010, FCS was confirmed as a permanent feature of the financial system.¹²

C.19 The FCS was developed over the period leading up to the global financial crisis, but its introduction was accelerated to support consumer confidence in the banking sector at the height of that crisis. It followed support for guarantee arrangements by the HIH Royal Commission in 2003, by the Council of Financial Regulators dating from 2005, and the Global Financial Stability Forum in 2008.

C.20 The Government committed to review the settings of FCS for depositors after three years. A consultation paper on the future of the FCS for depositors was released in May 2011.¹³ That process led to the announcement of a new cap of \$250,000 per depositor per ADI from 1 February 2012 in place of the current cap of \$1 million per depositor per ADI.¹⁴ The amounts available to meet payments and administer the FCS for insurance policyholders is capped at \$20.1 billion per failure.¹⁵

C.21 APRA is responsible for the administration of the FCS. Under FCS any payments to eligible depositors or general insurance policyholders will be made out of APRA's Financial Claims Scheme Special Account.

C.22 In the event of a payout to depositors or policyholders, the Government meets the cost of the payments in the first place, but recovers these costs when the failed ADI or general insurer is wound up. Should the available assets be insufficient, a levy is applied to industry to recover the difference between the amount expended and the amount recovered in the liquidation process.

Compensation arrangements for superannuation funds

C.23 The superannuation industry is subject to a prudential regulatory system. APRA supervises trustees of superannuation funds but allows trustees a degree of

11 Deputy Prime Minister and Treasurer, Media Release, *New Protections for Depositors and Policyholders and Financial System Legislation Amendment (Financial Claims Scheme and Other Measures) Act 2008*, 2 June 2008.

12 Deputy Prime Minister and Treasurer, Media Release 91, *A Competitive and Sustainable Banking System*. 12 December 2010.

13 The Treasury, *Financial Claims Scheme Consultation Paper*, May 2011.

14 Deputy Prime Minister and Treasurer, Media Release 109, *New Permanent Financial Claims Scheme Cap to Protect 99 per cent of Australian deposit accounts in full*, 11 September 2011.

15 The *Banking Act 1959* establishes the Early Access Facility for Depositors as the mechanism for making payments to depositors under the FCS, and the *Insurance Act 1973* establishes the Policyholder Compensation Facility as the mechanism to protect certain policyholders under the FCS.

freedom to operate their funds. This regulatory approach aims to minimise rather than prevent failure of the superannuation funds.

C.24 In 1993, the then Government introduced legislation which aimed to strengthen the security of superannuation savings and protect the rights of superannuation fund members.¹⁶ The Explanatory Memorandum stated that one of the most important elements of this package of measures was ‘for financial assistance to be provided to funds that have suffered a loss due to fraudulent conduct or theft’.¹⁷ This policy intent was the basis for Part 23 of the *Superannuation Industry (Supervision) Act 1993*.

C.25 Under Part 23 of that Act a trustee of an APRA-regulated superannuation fund (or approved deposit fund) can apply to the Minister for a grant of financial assistance if the superannuation fund incurs a loss as a result of fraudulent conduct or theft.¹⁸ The Minister is required to seek advice from APRA and must be satisfied that the loss has caused a substantial diminution of the fund leading to difficulties in the payment of benefits, and that the public interest requires a grant to be made.

C.26 The Minister has discretion over the grant of financial assistance up to the amount of the eligible loss.

C.27 The financial assistance granted in this way is funded initially from the Consolidated Revenue Fund and can be recouped through an industry levy on APRA-regulated superannuation funds and approved deposit funds.¹⁹ The effect is that a loss in one superannuation fund is borne by the members of other funds that contribute to the levy.

C.28 The Minister has a discretion to impose conditions on the grant of financial assistance and can use this discretion to impose a requirement that any monies recovered from the perpetrator of the fraud or theft against the superannuation fund be refunded to the Commonwealth up to the amount of the grant.

C.29 Part 23 specifically excludes self-managed superannuation funds (SMSF) from being able to apply for financial assistance under Part 23.²⁰ This is on the basis that SMSF members, as trustees of their SMSF, have direct control over their superannuation savings and are in a position to protect their own interests. The trustees of an SMSF, in circumstances where they qualify as retail clients under the Corporations Act, have rights to compensation in line with other retail clients.

Compensation arrangements for credit providers

C.30 A provider of consumer credit and credit-related brokering services and advice must hold an Australian Credit License under the *National Consumer Credit Protection Act 2009*.²¹ In some instances, an Australian Financial Services Licensee

16 *Superannuation Industry (Supervision) Act 1993*.

17 *Superannuation Industry (Supervision) Act 1993*, Explanatory Memorandum.

18 Part 23 applies to a regulated superannuation fund or an approved deposit fund but not a self managed superannuation fund.

19 *Superannuation (Financial Assistance Funding) Levy Act 1993* and the *Superannuation (Financial Assistance Funding) Levy and Collection Regulations 2005*.

20 The Minister may grant financial assistance to SMSFs under s231 (3) of the *Superannuation Industry (Supervision) Act 1993* where a fund was an APRA-regulated fund at the time the fund suffered the loss.

21 Generally commenced on 1 July 2010, or 1 January 2011 for ADIs and Registered Financial Corporations.

may also hold a credit licence. A financial planner who also advises on mortgages, for example, will be subject to a dual regulatory regime, including compensation arrangements imposed under both the financial services and credit regimes.

C.31 Credit providers are required to have an IDR process, to be a member of an EDR scheme and to have adequate compensation arrangements for loss or damage to the consumer as a result of a breach of an obligation of the credit licensee, such as the obligation to ensure they do not provide a credit contract that is unsuitable for the consumer. These consumer protection mechanisms are broadly similar to those that apply to Australian Financial Services Licensees.

C.32 Under the regulations for credit providers, the obligation of the licensee to have compensation arrangements can be met by holding professional indemnity insurance cover that is adequate.²² Licensees who are APRA-regulated insurers or ADIs are exempt from the requirement to hold professional indemnity insurance. In assessing the adequacy of the cover, the licensee is to have regard to:

- the maximum claim likely to be made against the licensee should a dispute be taken to an EDR scheme; and
- the credit activity undertaken by the licensee.

C.33 An overview of the compensation arrangements that apply to financial services licensees is provided in Table 2.2.

²² *National Consumer Credit Protection Regulations 2010.*