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22 May 2011

Statutory Compensation Review
Future of Financial Advice
PO Box 6295
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Submission to the Statutory Compensation Review (Future of Financial Advice)

This submission is made by the Association of ARP Unitholders Inc (the Association) in response to the Consultation Paper prepared by Richard St. John, April 2011.

The objectives of the Association are:
" To represent and promote the interests of investors in entities managed by or otherwise associated with (or formerly managed by or associated with) Trio Capital Limited (including the ARP Growth Fund), to lobby relevant authorities in respect thereto, to seek compensation for members in respect thereto, to provide information to members in respect thereto and to undertake activities incidental thereto. "

The Association has previously responded to the Future of Financial Advice Options paper with a submission dated 21 February 2011, urging improved levels of regulatory protection for Self Managed Superannuation Funds (SMSF's).

That submission, a copy of which forms an appendix to this document, is complementary to it and should be read in conjunction with it.

A. Brief Recent History of ARP Growth Fund

The comments made in this submission with regard to the compensation arrangements for consumers of financial services are particularly framed in response to the experience of the 74 unit holders of the ARP Growth Fund. This Fund holds superannuation assets that in August 2009 were reported to amount to approximately $54 million.

The collapse of Trio Capital Limited in late 2009 led to the ARP Growth Fund being one of five Trio Capital Funds wound up by Court order issued by Justice Palmer in April 2010, the result of what he described as a "scandalous fraud". In May 2010 the liquidators, PPB, issued a report into ARP Growth Fund in which they ascribed a nil current value to the assets in the fund.

Bill Shorten, the Assistant Treasurer and Minister for Financial Services and Superannuation, recently announced that all APRA regulated superannuation funds associated with Trio Capital would have 100% of their lost assets reimbursed under the provisions of Part 23 of the *Superannuation Industry (Supervision) Act (SIS)*. . However, all SMSF's associated with Trio Capital (under ATO regulation) would receive no reimbursement.

The majority of ARP Growth Fund unit holders are either elderly pensioners, or baby boomers approaching retirement. Most had been clients of the same superannuation/financial adviser for the previous two decades. Many had all, or nearly all, of their investments in the ARP Growth Fund.

As a result of the Fund being wound up with assets of no current value, all unit holders have had their asset base significantly reduced. Many are now effectively destitute, with their life time superannuation investments wiped out at a point at which they have little hope of replacing them via re-entry to the work force. For this group in particular, the failure associated with the Trio Capital has truly been catastrophic in its impact on many of their lives.

Investigations into the affairs of ARP Growth Fund by ASIC and PPB has been protracted and remains on-going. Over twelve months has passed since PPB placed a nil valuation on the ARP Fund. Evidence of the underlying assets and their value is still not available to Unitholders, nor has any person or persons being charged with possible offences as detailed in the PPB report to unit holders on 18 May 2010.

B. Compensation arrangements for financial services consumers

The Association has closely studied the Richard St. John Consultation paper and would like to comment as follows:

1. *Insurance as a means of compensation is deficient, particularly under catastrophic situations*

   Professional indemnity insurance as a means to compensate complainants has failed in the case of ARP Growth Fund members. The insurance cover and arrangements in place for Trio Capital have been inadequate to even begin to satisfy the number of claimants and the quantum of funds lost. This fact is also true of PI cover in place in the supply chain leading to Trio Capital. Namely, at the Dealer Group level (Wright Global Pty Ltd in liquidation) and at the adviser/investment manager level (PST Management Pty Ltd in liquidation).

   For example, PST Management Pty Ltd hold PI cover of $5 million, which is less than 10% of the assets "lost". Wright Global Investments Pty Ltd holds a similar amount of PI cover. Putting aside the difficulty and legal expense of recovering under such a policy, the quantum available means that no substantive level of compensation for loss is possible, even if a legal action is successful.

   This situation is made more difficult by the tendency of groups caught up in these situations to go into liquidation, as has now happened not only with Trio Capital but also PST Management and Wright Global. This means that any monetary compensation has to be directed towards the PI insurer only, as the licensee is no longer in a position to meet the liability.

   In the case of the unit holders of ARP Growth Fund, where the average client assets under management (AUM) was in excess of $750,000, the lack of compensation is compounded by the fact that for many this amounts to a financial wipe out of their entire superannuation fund. As many are pensioners of advanced age, this means that many have been reduced to levels of near poverty at a time when their capacity to return to the workforce is well nigh non existent.

2. *Run-off cover is essential*

   In the case of ARP Growth Fund unit holders, great uncertainty as to what exactly was happening with unit holder funds existed for many months and was not clarified until well after the PI cover was no longer in place. There was no opportunity to even lodge claims at this point, should a unit holder have wished to do so.

3. *Insurance caps need to be realistic if it is to deal with a catastrophic occurrence*

   PI insurance needs to be able to deal with situations such as ARP Growth Fund, but is currently not well set up to do so. PI cover is unsuited to respond to situations where multiple large claims arise, which means that the aggregate quantum exceeds even large cap amounts. This situation is made worse when the licensees are unable to meet the excess from their own financial resources.

4. *Liquidators are reluctant to pursue insurance claims in catastrophe situations*

   Liquidators have the right to pursue claims on behalf of claimants in cases where the licensee becomes insolvent, but in the case of ARP Growth Fund this has been found to be largely academic as the liquidator faces a real life situation where not only do the amounts claimed overwhelm the PI cover, but their own fees are no longer guaranteed due to the fact that the Fund has no value. They are therefore reluctant to act, as this will incur additional expenses for them which are unlikely to be recovered.

5. *Policy conditions and exclusions need to be publically available*

Claimants and potential claimants in catastrophic situations often find themselves in desperate situations. In the case of ARP Growth Fund members, all principle parties who carry PI cover are in liquidation, the liquidators have no or limited funding to act on the behalf of claimants, and the potential claimants themselves have much reduced financial circumstances.

Engaging expensive legal advice under these circumstances is an uncertain and limited option. The uncertainty is however much worsened by the refusal of PI insurers to make available to claimants the policy conditions governing the specific PI policy, so that they have no way of knowing what their right may be unless they launch expensive legal action.

Pursuing PI compensation under such circumstances becomes well nigh impossible and direct action by ASIC on behalf of those affected becomes the only viable option (as in the case of Westpoint).

6. *Summary views of ARP Growth Fund Association*

ARP Growth Fund investors trapped in the above web of difficulty report feeling that they are powerless to react effectively and that they have been caught up in a "perfect storm" Recent market research conducted on behalf of ASIC supports this view and suggests that it is wide spread amongst those who have suffered financial loss as a result of misconduct. The research, conducted by Susan Bell Research, found that the social impact of major financial loss could be "catastrophic". .

Many investors felt that their loss was "so significant that their lives would never again be the same" and felt prolonged anger, uncertainty, worry and depression. They also felt a lack of confidence in the Australian financial system, including the Federal Government and ASIC.

a. The Association believes that the current compensation arrangements for SMSF's require revision to better cater for catastrophic situations, as has occurred in the case of ARP Growth Fund Unitholders. Clearly the retail SMSF protection safeguards currently in place are woefully inadequate, or in this case, are simply unworkable, as outlined above.
b. The difference in compensation approaches between regulated funds and SMSF's under Part 23 of SIS clearly has given rise to an inequitable two tier system of retail investor protection that cannot be justified under these circumstances.

   A better solution needs to found for circumstances where both regulated funds and SMSF trustees have been the victims of the same external third party fraudulent misconduct or theft.

c. The Association is not suggesting that compensation be always guaranteed, but that where it is given, that it should not be done in an arbitrary manner that benefits only a selected group of retail investors (regulated funds) over another group of retail investors (SMSF's).
d. Grants of financial assistance by the Federal Government under Part 23 of SIS to only one of the two groups has no logical or moral basis and amounts to poor public policy. It is unsustainable and clearly will need to be remedied at some point. The Association believes that the current review is the appropriate time to do so.

C. Points needing clarification

1. The review is solely concerned with the financial security of retail clients. There seems to be some confusion as to when and even whether SMSF's are included under the retail classification. (Refer also appendix 1).

D. Recommendations

1. ***The Association recommends that the Federal Government investigate the establishment of a statutory compensation scheme, the design of which will need to adequately protect consumers caught up in extreme situations outside of their control. Such a scheme should extend to SMSF's***

   Explanatory note: The Association believes that relying on professional indemnity insurance compensation to cover all possible financial service licensee wrong doing does not work. It has too many limitations, especially as a last resort statutory compensation scheme and in cases of catastrophic loss, as per ARP Growth Fund unitholders. There needs to be a financial services provider equivalent of the National Guarantee Fund (NGF) which has been operating for clients of the ASX since 1987. The NGF has many investor protection features which would make it an excellent model. The Financial Services Compensation Scheme (FSCS) run in the United Kingdom provides an external model which also has much to recommend it.

2. ***The Association recommends that SMSF's with assets under $10 million, who are explicitly recognised as enjoying full retail fund protection in terms of the Corporations Act, also enjoy similar retail protection as afforded to APRA regulated retail funds, under Part 23 of SIS.***

   Explanatory note: Refer the summary notes under section B.6 above. This may require the creation of a suitable levy system (or similar) to fund the operation of the scheme.

3. ***The Association recommends that PI insurance cover have legislated higher minima so that at least 25% of the funds at risk are covered, subject to agreed maxima and minima.***

   Explanatory notes: There is clearly an ongoing role for PI insurance in a wide range of situations, excepting perhaps the proposed "last resort" coverage. This PI cover needs to be adequate to meet the reasonable expectations of claims that might be made in the normal course of events. In the case of ARP Growth Fund, the minimum PI insurance should therefore have been $13.75 million, not the actual $5 million (25% of $54 million). Such an approach would also need to include a minimum amount of PI cover (suggest $10 million) and would need to phase out at an agreed maximum (suggest $100 million).

4. **The Association recommends that the policy conditions providing such PI cover for each licensee should be made publically available at all times to investors in the funds.**

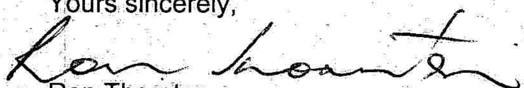
   Explanatory note: Refer B.5 above. Any policy exclusions should be highlighted prior to the investor making an investment decision and should be subject to the approval of ASIC. Key "standard cover" inclusions should be made mandatory to provide comprehensive cover to investors and ASIC should sight on an annual basis a current certificate of currency.

5. **The Association recommends that PI policies should all carry legislated run off cover for a minimum of 18 months.**

   Explanatory note. Refer B.2 above

Please do not hesitate to contact the undersigned should you require any further information.

Yours sincerely,



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Appendix 1.

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21 February 2011

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1. **Self Managed Superannuation Funds (SMSF's) need improved levels of regulatory protection.**

   a. The Association wishes to make a specific point in relation to the discussion on the distinction between retail and wholesale clients in regard to those clients considered to be in need of regulatory protection.

   b. Following the *Wallis Inquiry* in 1997, the *Corporations Act* was amended by the *Financial Services Reform Act 2001* to establish a difference between the levels of consumer regulatory protection offered to retail and wholesale clients.

   c. Generally retail clients enjoy a higher level of consumer protection as they are deemed to be less well informed and therefore less well able to assess the risks involved in financial transactions.

   d. The one notable retail exception to this general principle appears to lie in the field of Self Managed Superannuation Funds (SMSF's), in particular in regard to the total exclusion of SMSF's from the consumer protection offered to the members of other regulated superannuation funds under part 23 of the *Superannuation Industry (Supervision) Act (SIS).*

   e. The Association questions the appropriateness of this broad exclusion and in particular the apparent total extent of its applicability. The Association believes it should be modified to better cater for situations in which SMSF retail members are clearly disadvantaged under circumstances in which *regulated* retail (and wholesale) superannuation funds may qualify for consumer protection under part 23 of *SIS,* yet SMSF retail clients in a precisely similar position are excluded from this protection.

   f. This is, in the view of the Association, an unintended anomaly which should be addressed as one of the outcomes of the Future of Financial Advice review process. By so doing, the Association believes that the Federal Government will be able to better provide regulatory protection to this significant and growing group of retail SMSF investors, in those specific circumstances where such additional protection is clearly warranted.

g. The absence of such protection appears not only to be confusing to such clients, but also to many providers of financial advice upon whose advice these clients initially base their superannuation decisions. The trustees of SMSF's are currently treated more like "professional investors", akin to the mostly professional trustees of large regulated superannuation funds, whereas they should in fact generally be regarded as less sophisticated retail clients. Indeed, many of them are retail small business owners.

h. The Federal Government is seeking to draw a line as to which investors need improved protection. The Association believes that the great majority of SMSF's clearly fall into the retail category and should be entitled to the greater levels of regulatory protection enjoyed by such clients, in specified situations of fraudulent conduct or theft.

2. What needs to be altered to improve levels of regulatory protection for SMSF's?

a. Currently only the trustee of an APRA regulated superannuation fund can apply to the Minister for a grant of financial assistance, if the fund suffers an "eligible loss" as the result of fraudulent conduct or theft. The same legislation specifically excludes the trustees of SMSF's, regulated by the Australian Tax Office, from applying for similar assistance, even under circumstances which are identical.

b. The Association believes that this outcome was never the intended outcome of the *2003 Review into Part 23 of the SIS Act (1993)*. The general philosophy underpinning the prudential regulation of superannuation is that the trustee of a superannuation fund bears primary responsibility for the fund's prudent operation. Nevertheless, recognising the importance of financial stability, the Government also applies an additional layer of prudential regulation to promote sound risk management. Furthermore, it is recognised in the *SIS Act* that in the case of fraud or theft that there is a case for Government intervention to provide compensation, in particular under part 23.

c. The exclusion of SMSF's from the part 23 protection was originally justified on the grounds that the SMSF trustees are also fund members. It was therefore assumed that the trustee(s) will act in their own best interest and that as a result "members do not need the full range of statutory measures to protect them in relation to the conduct of the trustee" (*Review page 4*).

d. While there may be some logic to this approach, it also carries clear limitations. The Association is of the view that this exclusion operates unduly harshly against the members of SMSF's under certain circumstances and needs to be amended to provide them with greater regulatory protection.

e. The circumstances in which improved protection is required are those in which SMSF trustees act in good faith and to the same standards as those trustees of regulated superannuation funds, and yet their members are grossly disadvantaged in cases of fraudulent behaviour and/or theft. The fact that, under the same set of circumstances, the members of the regulated funds are eligible to apply for compensation, whereas the members of a SMSF are not, is clearly one capable of causing gross inequity.

f. The anomalous treatment of SMSF's is well illustrated in the current case of the liquidation of the superannuation funds managed by *Trio Capital*, including the *ARP Growth Fund*. These Funds were wound up in the Courts in 2010, Justice Palmer being moved to remark that the events which led to this liquidation amounted to a "scandalous fraud". The Trio Capital funds included both regulated superannuation funds and SMSF's.

g. The trustees of both types of funds made their investment decisions based upon information provided from the same documentation, using identical product disclosure statements issued under the guidelines of, and with the approval of, the appropriate Australian Government Regulator. (It has indeed even been suggested in the media that the product disclosure statements themselves were deficient in terms of the use to which investor money was to be put.)

h. Both sets of trustees clearly formed the view that, based upon the information provided in those Regulator approved documents, it was in their members' interest to invest in the Trio Capital managed products. Yet when it turned out that they had all been subject to the same complicated deception and fraud, only the members of one group had an avenue of appeal open to them under part 23, namely those under regulated funds.

i. In a post GFC environment in which improved investor protection is a stated Government priority, it is no longer possible to justify the discriminatory treatment suffered by members of SMSF's such as outlined in the case above. The Minister for Financial Services and Superannuation, in his response to the Cooper Review, has promised to provide superannuation members with improved levels of protection and this is clearly a case where such improved protection is required.

3. Recommendation

The Association believes that public policy dictates that an improved level of protection for SMSF members is warranted under the extreme conditions outlined above. The Association therefore recommends that the Federal Government move to include the ability for SMSF members, who act in good faith and who are nevertheless the innocent victims of fraudulent behaviour or theft by external third parties, to be able to apply to access the provisions of part 23 of the *SIS Act*.

Please do not hesitate to contact the undersigned should you require any further information.

Yours sincerely,

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