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Manager
Statutory Compensation Review
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Dear Sir/Madam

Statutory Compensation Review Submission

The Superannuation Committee (**Committee**) is a committee of the Legal Practice Section of the Law Council of Australia. Its objectives include ensuring that the law relating to superannuation in Australia is sound, equitable and demonstrably clear. It fulfils this objective in part by making submissions and providing comments on the legal aspects of proposed legislation, circulars, policy papers and other regulatory instruments.

The Committee read your report and would like to take the opportunity to compliment you on its thoroughness and quality.

As lawyers practising in superannuation law, the Committee does not have the specialist knowledge or experience which is needed to comment on the many specific issues raised in your paper. However, the Committee would like to bring to your attention several issues which the Committee thinks should be taken into account in your consideration of whether a statutory "last resort" compensation scheme should be available to all "retail clients" who have suffered loss or damage as a result of the misconduct of an Australian financial services licensee.

Issue: Superannuation fund members bearing the cost of claims brought by other members

A superannuation trustee's right of indemnity has, the Committee considers, a key bearing on whether it is appropriate for superannuation funds to participate in a statutory compensation scheme of the sort being considered in your paper. This issue affects members of superannuation funds and, in the Committee's view, is likely to have a greater

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impact as the commercial and regulatory environments change and more members access financial product advice through their superannuation funds. Consistent with the findings in your paper that claims against advisers relating to poor financial product advice are increasing, it can be anticipated that where more superannuation fund members are provided with advice by, or arranged by, the trustee of their superannuation funds, more members will bring claims against their trustee relating to that advice. In this sense trustees who provide financial product advice to their members will be treated by members in the same way as advisers who provide financial product advice to their clients. However, a superannuation trustee and an adviser are in very different positions when it comes to satisfying a successful claim. This, in turn, affects other fund members in a way that a successful claim against an adviser would not affect other clients of the adviser.

Background: Advice provided by or on behalf of superannuation trustees

Most superannuation fund trustees hold an Australian financial services licence ("**AFSL**"). In most cases a licence will authorise the trustee to provide financial product advice to retail clients.

Consistent with this, trustees of superannuation funds routinely give general advice to their members. A common example is an opinion expressed in a product disclosure statement (**PDS**) about the benefits of investing in superannuation or in the specific superannuation product being offered in the PDS (it is a requirement to include statements about the benefits of a product in a PDS).

Increasingly superannuation trustees also provide members with personal advice. The Australian Securities and Investments Commission (**ASIC**) issued class order 09/210 which allows superannuation trustees and their authorised representatives to provide "intra-fund advice" to their members without complying with section 945A of the Corporations Act. Advice is provided by the trustee or, in the Committee's experience more commonly, through an agent of the trustee or another service provider. Advice will typically relate to investment options and insurance held by the member.

Recently, the Super System Review Committee's report recommended that trustees offering MySuper products be required to provide personal advice to members in certain circumstances.

A goal of the Government's Future of Financial Advice reforms is to increase access to financial product advice. The Government proposes to promote a new class of financial product advice, called "simple advice". While the details are sketchy at this stage, it appears that relief from section 945A of the Corporations Act will be granted to the providers of simple advice. Simple advice would include "intra-fund advice" currently provided for under the ASIC class order 09/210.

In this context the Committee considers that some consideration should be given to the unique position of superannuation fund members when advice is provided to members by the superannuation fund's trustee or their agent. Further, should a statutory compensation scheme be recommended, the Committee considers that there are strong policy reasons to support exempting trustees of APRA regulated superannuation funds from contributing to the scheme. Our reasons are set out at the end of this letter.

Discussion: How does the cost of individual claims get spread amongst fund members?

In your paper you describe the compensation arrangements which are currently available to retail clients of licensees. You note that recourse is generally limited to complaints or proceedings, in tribunals or courts, brought by the client or in some cases ASIC against the licensee. Any damages or compensation orders must be satisfied from the licensee's personal resources. Under section 912B of the Corporations Act, these resources must include an appropriate professional indemnity insurance policy.

Financial assistance under Part 23 of the SIS Act

In the context of superannuation, a fund which suffers a substantial loss because of fraud or theft can also access compensation, in the form of financial assistance from the Government, under Part 23 of the SIS Act. The Government is then able to recoup the amount paid to the fund through a levy on all APRA regulated superannuation funds. As a consequence, Part 23 creates a scheme whereby all APRA regulated fund members effectively insure members of funds against substantial loss due to theft or fraud. The Government has recently exercised its powers under Part 23 in promising financial assistance to a number of funds operated by the Trio Group of companies. It has also announced that it will be imposing a levy on all APRA regulated superannuation funds.

Trustee's right of indemnity: introduction

This scheme reflects a policy decision by Government. On a smaller scale, the general law right of indemnity from fund assets which trustees of superannuation funds enjoy, together with the protection provided to that indemnity under section 56 of the SIS Act, can give rise to circumstances whereby the members of a superannuation fund as a whole effectively insure individual members of the fund against loss or damage caused by the trustee.

An example of the cost of an individual claim being spread

For the purposes of this submission, the following example is relevant: a member may commence proceedings against the trustee for recommending a particular level of insurance cover. The trustee (or its agent) may have recommended a particular level without taking into account the member's relevant circumstances. The trustee is ordered to compensate the member for the loss. The trustee in turn is able to satisfy its compensation liability from the fund. As a consequence, the members of the fund will assume the cost of compensating the individual member.

While it is possible that there may be public policy grounds on which to support the allocation of risk associated with trustee conduct to members, in the Committee's opinion, this should be the result of a considered decision by Government, not the outworking of law developed for very different purposes in a vastly different environment.

Trustee's right of indemnity: further details

A trustee's right of indemnity at general law protected trustees who were volunteers with, often, very narrow duties, in particular to protect and invest trust property for the benefit of the beneficiaries and to distribute that property. Similarly, section 56 of the SIS Act was drafted when most funds were corporate funds established by employers for their employees. Again, trustees (and their directors) were volunteers. The trustee's right of

indemnity was not intended to protect professional trustees from liability for poor advice or breach of their statutory obligations.

At general law a trustee is entitled to be indemnified from fund assets for any liability or loss they incur in connection with their administration of the trust. There is much debate and many cases dealing with the scope of the trustee's right of indemnity and, in particular for these purposes, whether it would allow a trustee to look to recover from the fund an amount needed to compensate a beneficiary for the trustee's wrongful act.

The general law position is modified for trustees of regulated superannuation funds. Under section 56 of the SIS Act a provision in the governing rules of a superannuation fund is void if: "*it purports to preclude a trustee of the entity from being indemnified out of the assets of the entity in respect of any liability incurred while acting as trustee of the entity.*" This extremely broad right is limited by section 56(2) which prohibits a trustee from being indemnified from the fund against "*liability for breach of trust if the trustee fails to act honestly in a matter concerning the entity or intentionally or recklessly fails to exercise, in relation to a matter affecting the entity, the degree of care and diligence that the trustee was required to exercise.*" The indemnity is also not available for "*liability for a monetary penalty under a civil penalty order*".

The protection of the trustee's right of indemnity gives superannuation fund trustees a very broad right of indemnity even for a loss caused by their misconduct provided that the misconduct was not a fraudulent or reckless breach of trust. It would, in the Committee's opinion, be very likely to be open to a trustee to satisfy from the fund an order to pay compensation relating to loss to a member caused by financial product advice given, to take the previous example, without the relevant personal circumstances of the member being taken into account.

Having said this, the Committee notes that despite the breadth of a trustee's right of indemnity, trustees will commonly not exercise that right, instead satisfying a claim from their personal resources or a claim under professional indemnity insurance. However, the point remains, that they are able to do so and, where the insurance policy does not respond or their personal resources are insufficient, they will have access to the fund. As a result, the members as a whole will act as the insurer for the trustee and in turn ensure that the individual member will be compensated.

The Committee notes that the position of a superannuation trustee is in stark contrast to the position of a responsible entity of a managed investment scheme, who is only able to be indemnified from the scheme for the proper performance of its duties.

Need for specific consideration

As noted above, it might be that the unique position of superannuation trustees who provide their members with financial product advice and their members can be supported on public policy grounds. However, the Committee thinks that it is very important that those grounds be considered and debated. The Committee hopes that you may be able to give some consideration to these issues in the conduct of your enquiries into the merits of a statutory last resort compensation scheme for retail clients who suffer loss or damage because of the misconduct of a financial services licensee.

Statutory compensation scheme: exemption for APRA regulated fund trustees

The Committee believes that there are two good policy reasons to exempt trustees of APRA regulated superannuation funds from being required to contribute to a statutory compensation scheme for retail clients who suffer loss or damage because of the misconduct of a financial services licensee. These are:

- retirement savings should not be used to fund a statutory compensation scheme of the sort being considered here; and
- superannuation fund members are less likely than other retail clients to need to resort to such a scheme. As a consequence, they should not be required to support the scheme.

Retirement savings: A financial services licensee who is required to pay a levy to fund a compensation scheme would, in the ordinary case, be required to pay the amount from their personal resources. As described above, a levy imposed on the trustee of a superannuation fund would, in the ordinary case, be satisfied from the assets of the fund. As a consequence, the members, not the trustee, would bear the cost of funding the scheme. The clients of other licensees would not do so, or at least not so directly.

Under Part 23 of the SIS Act, trustees of APRA regulated funds are, as noted above, already required to contribute to a statutory compensation scheme. The effect of imposing a levy on funds under this scheme is to apply the assets in all APRA regulated funds to protect the retirement savings of the members of a fund which suffers a substantial loss because of fraud or theft. As a consequence, the impact of fraud or theft in the superannuation industry affects the retirement savings of the members of all APRA regulated funds. The scheme reflects a policy decision of Government. Further, the scheme applies in very limited circumstances and has been used rarely. The Committee does not think that using retirement savings to provide a compensation scheme for the retail clients of financial advisers and licensees more broadly can be supported on policy grounds, particularly in circumstances where other licensees are required to satisfy a levy from their personal resources.

Use of compensation scheme by fund members: Members receiving advice from their trustee have considerably greater prospects of recovering compensation from their adviser (the trustee) than clients who receive advice from a non-trustee adviser. This is because the assets to which members of APRA regulated superannuation funds could potentially have recourse (when claiming compensation for trustee-adviser misconduct) would far exceed the policy limits and net tangible asset holdings backing traditional advisers. Those members are already in a satisfactory and better position (if the trustee right of indemnity applies). Alternatively put, given that it is highly unlikely that the assets of an APRA regulated superannuation fund would ever be entirely depleted, members who receive advice through their trustee would almost never be entitled to make a claim under a true "last resort" compensation scheme. That being the case, it would seem unfair for those members to have to contribute towards any levy or costs of funding such a scheme.

Matters for consideration

In the Committee's view, the proposal for a statutory compensation scheme raises many issues which point to the conceptual difficulty of trying to apply such a scheme to APRA regulated funds. The Committee has set out a number of these issues below:

Definition of retail client: Before extending any compensation scheme to all retail clients who receive advice, careful consideration needs to be given to the meaning of "retail client" in the superannuation context. The Corporations Act defines all members of superannuation funds to be retail clients, irrespective of their financial position. It would be anomalous if a client who had lost $500,001 in connection with advice received from a traditional adviser were to fall outside of any new compensation scheme, but a member who had lost $5 million in connection with advice received from their trustee were to be covered by the scheme.

Similarly, any superannuation fund with assets of less than $10 million that invests in a pooled superannuation trust would be regarded as a retail client vis a vis the trustee of the pooled superannuation trust. It would perhaps be anomalous if a superannuation fund (with the possible exception of a self managed superannuation fund) were to be covered by any new compensation scheme by virtue of its deemed status as a retail client.

There would also appear to be some reason to exclude self managed superannuation funds from any new compensation scheme. Given the nature of those funds, it raises the policy question of whether assets of a compensation scheme should be capable of being accessed by members of a self-managed superannuation fund for losses suffered in connection with advice that was essentially provided by themselves or a close family member.

Types of advice covered: Consideration should be given to limiting any new compensation scheme to personal advice and excluding general advice. A policy question arises as to whether the assets backing a compensation scheme should be capable of being accessed for losses suffered by clients who were on notice that the advice was general and had not taken into account their personal objectives and circumstances.

While whether general advice should be excluded from such a scheme is an issue which affects the financial services industry more broadly, excluding general advice would also avoid the related question of whether unlicensed trustees (e.g. non public offer funds) would need to be covered by any new compensation scheme on account of general advice provided through disclosure documents, member educational material, online calculators and risk profilers.

Last resort funding schemes: It has been suggested that a future "last resort" funding scheme might be funded by a revenue based levy. If this were to be the case, and if superannuation funds were to be covered by the scheme, consideration should be given to limiting the levy calculation to revenue linked to advisory services. Superannuation funds could otherwise be required to contribute disproportionately to the scheme if the levy were calculated on total revenue, especially in cases where advisory activities represent a very small proportion of the trustee's total activities.

If general advice were to be covered by the scheme, it should be noted that trustees would typically not charge for such advice. Consequently, it is conceivable that claims

might be made under a scheme in connection with trustee-advisers who had never contributed towards a levy on account of not generating any revenue from their activities.

Other comments on the paper

In reading the paper, the Committee noted a number of other issues. The Committee notes that these are not directly relevant to superannuation funds and their members. However, they are matters which would affect them if, contrary to the Committee's preference, APRA-regulated funds are included and, in either case, are worthy of consideration.

Cap on amount of claim: Reference is made at page 95 of the paper to a proposal that would limit the amount of a client's potential claim on a compensation scheme, initially to a proportion of their total loss suffered, but ultimately limited to circa $200,000. Consideration should perhaps be given to linking the claim cap to the Corporations Act definition of "retail client". Given that the scheme would apparently only apply to retail clients, and given that, for convenience, these clients might be assumed to have invested less than $500,000 , the question is whether, as a matter of policy, it is desirable to create a scheme that inevitably allows for these people to lose 60% of their personal (invested) assets.

Similarly, for fairness and equity reasons, consideration should be given to extending a last resort scheme to all natural persons who suffer losses in connection with advice; otherwise a client who received advice to invest $500,001 might fall totally outside of the scheme.

Circumvention of a statutory last resort scheme: In designing a purported "last resort" scheme, consideration should be given to how the "last resort" aspect could be circumvented in practice and whether this is something that should be allowed. For example, the "last resort" nature of the scheme would imply that it could only be accessed after insurance policies had been exhausted, and presumably insurers would not be entitled to make a claim against the scheme on a subrogated basis. However, there are examples of existing "last resort" schemes being pursued by insurers. For example, if the insurer were to indirectly compensate the underlying clients, not by paying a claim under the policy to the insured adviser, but instead by purchasing an assignment of the rights which the underlying clients might otherwise have against the "last resort" scheme, the insurers may be able to bring a claim against the scheme in the name of the underlying clients (and recover any proceeds). In other words, consideration should be given to how legal principles of champerty and maintenance ought to reply to rights to claim on a 'last resort' scheme.

Contractual limitation of liability: Consideration should also be given to whether it is appropriate for advisers to be entitled to limit their liability to clients for advice-related losses. Contractual limitations of liability could potentially defeat the purpose of any improved compensation regime. Otherwise, it is conceivable that clients might only be able to recover a small proportion of their losses from an adviser with substantial assets and considerable insurance coverage.

If contractual limitations of liability were to be accepted, then this should be a consideration when mandating contributions to any "last resort" compensation scheme. Arguably, advisers with limited liability should be required to contribute to the scheme on a reduced basis, given that their clients would presumably never be able to make claims as

large as another adviser who, although having a comparably sized advisory business, has chosen not to limit its liability to its clients.

Disclosure of insurance policies: There is some suggestion in the paper that advisers be required to disclose the levels of their insurance cover. While this may sound like a simple proposition, in practice, it is likely to be very difficult for clients to meaningfully compare advisers based on insurance coverage. This is because it is not as simple as quoting the dollar limit on claims. Different advisers will have very different insurance structures and arrangements, often comprising multiple layers. For example, the first $20 million of losses may be insured. The next $20 million of losses may be uninsured; and losses over that might be insured, subject to a further limit of another $20 million. Similarly, there may be very different deductibles. An adviser with $50 million of insurance may appear to have 'more' insurance than an adviser with $20 million of insurance; but this may not be the case if the $50 million policy has a deductible of $20 million. Also, insurance policies may apply to an entire corporate group and potentially cover different business activities. Two advisers who appear to have the same level of insurance cover may not genuinely offer comparable reassurance or comfort to clients, if one of the adviser's policy limits might be depleted by claims brought by other entities within their corporate group for other types of business activities. Ultimately, the amount of coverage is a blunt measure of protection and true coverage will depend on the scope of policy inclusions and exclusions and these are unlikely to ever be disclosed in any meaningful detail. It should also be noted in passing that there is a tendency for insurance levels to be under-disclosed (i.e. for insureds to understate their true level of cover to clients).

The Committee would be happy to provide further detail in respect of its submission if it would be of assistance.

Yours sincerely,

Bill Grant
Secretary-General.