



# Review of Compensation Arrangements for Consumers of Financial Services

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## 1. Executive summary

Professional Investment Services (PIS) is Australia's leading independently-owned network of financial advisers and accountants.

As an organisation and member of the financial advice industry, we believe consumer protection, which involves appropriate compensation mechanisms, is paramount for consumer confidence and the integrity of the financial services industry.

We welcome the review of compensation arrangements and the opportunity to provide our feedback on the adequacy of compensation arrangements for consumers of financial services.

In considering the issues and recent corporate collapses we believe **the primary reason** for client loss arises out of **corporate failure, and the insolvency of product providers**, rather than advice based failures. The current review however does not propose to deal with loss or damage suffered as a result of investment failure which has the potential to limit the effectiveness of any proposed compensation arrangements and is not likely to address the issue of client loss.

**On the basis that any statutory compensation scheme is only proposed to cover loss or damage as a result of licensee misconduct we do not support a statutory compensation scheme of last resort.**

Further details of our comments and observations of the causes for client loss, key stakeholder responsibility and concerns around a statutory compensation scheme are considered further below in our submission.

## 2. Introduction

As outlined in the consultation paper, the current regulatory framework provides a fairly well developed system in place to protect consumers in the financial services sector<sup>1</sup>. This includes a combination of an accessible and affordable dispute resolution regime at no cost to client (such as FOS), minimum capital adequacy and professional indemnity insurance requirements, as well as a regulatory regime designed to protect the consumer and maintain market integrity. This framework collectively serves to protect the consumer in the event that a client suffers loss as a consequence of inappropriate advice whilst still providing clients access to advice which is affordable.

In spite of the well-developed regulatory framework in place, there will however be instances in which consumers suffer investment loss as a consequence of corporate failure, fraud and inappropriate advice.

It is essential that consumers have access to compensation mechanisms in order to ensure appropriate consumer protection, foster consumer confidence and maintain market integrity. In providing consumer protection however it is also essential that there be a balance between that protection and the costs and benefits associated with managing the financial risk.

A statutory compensation scheme for losses arising out of licensee conduct is one means of providing consumers with access to compensation. In offering such a scheme however the potential benefits must be weighed up against the costs. It is also essential to assess whether there is in fact a necessity for such a scheme when considering the primary reason for consumer loss arises out of investment failures<sup>2</sup>, which the compensation scheme explicitly proposes not to cover.

## 3. Corporate Failure Rather than Advice Based Failure

We are concerned that a statutory compensation scheme for advice based failures, or losses associated with licensee conduct, may simply be addressing a symptom instead of using the opportunity of assessing consumer protection and compensation arrangements to recognize and address the wider problems associated with corporate failures . This requires recognition that client loss arises out of corporate failures which may be attributable to; market failures (are the extensive agribusiness managed investment scheme (MIS) failures in the past few years representative of wider market failure?), directors and management (poor management, excessive leverage, over reliance on future income to sustain the business model), the role of auditors in adhering to audit standards and signing-off accounts as a going concern shortly prior to a business' collapse, the conduct of the

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<sup>1</sup> As recognized in the Consultation Paper, p78.

<sup>2</sup> Opes Prime, Bridgecorp, Fincorp, Westpoint, Great Southern, Timbercorp, FEA, Trio Capital, Rubicon International Leaders Fund (capital protected).

Trustee and whether it acted to protect investor's interests, the responsibility of external and internal research and of course whether the advice provided was appropriate to the client.

Each of these components are key stakeholders in the value chain which may in fact attribute to the loss suffered by consumers and are considered in further detail below. It is our view that product providers, auditors, trustees, management and directors, together with researchers and advisers all collectively have the responsibility to perform their function in accordance with their professional and legal obligations in order to prevent investor losses.

Where these key players fail to perform their role in accordance with their legal and professional requirements then they should be held accountable and liable for their involvement in the overall failure, similar to the measures taken by ASIC with respect to Westpoint in commencing compensation action against the Directors, the Auditor, Trustee and financial advisers. Failure to do so will not provide consumers with adequate protection or provide appropriate compensation under the statutory compensation scheme for losses arising from Licensee misconduct.

#### **4. Statutory Compensation Scheme – Associated Risks**

In addition to the concern that the compensation scheme will not provide consumers with compensation or protection, due to the causes for client loss, we are also concerned that the costs involved with the statutory compensation scheme will in fact disadvantage consumers overall.

Consumers will be forced to pay increasing fees for the provision of advice, as Licensees and Adviser costs increase to meet compensation scheme contributions which will correspondingly serve to decrease accessibility to advice. The effect of this on investors who choose to invest their funds with well governed businesses, with strong capital backing will effectively be to subsidise those investors who choose to invest their money with a firm which does not possess those attributes.

Furthermore, there is the very real risk of increasing moral hazard. The existence of a statutory compensation scheme may change investor conduct providing less incentive upon investors to carefully consider whether they are dealing with an individual or institution which has a reputation for quality advice, good corporate governance and financial strength. Furthermore, and of greater concern and social impact, the compensation scheme may encourage increasingly risky investment behavior which may in turn magnify client losses.

What must be understood is that increased consumer protection will come at a corresponding cost to advice. As regulatory reform under Future of Financial Advice serves to drive up the cost of advice, so too will a statutory compensation scheme. We are concerned that the increasing costs to the consumer, as well as the risks associated with moral hazard, outweigh the potential benefits of such a

compensation scheme which is only focused on losses arising out of Licensee/adviser misconduct and not actually addressing the problem.

## **5. Corporate Failures**

The real issue and cause for client loss primarily arises from corporate failure. Opes Prime, Bridgecorp, Fincorp, Westpoint, Great Southern, Timbercorp, FEA, Willmott, Trio Capital, Centro are all examples of corporate failures. Commercial failure may be attributable to poor management, excessive leverage and over reliance on future income. Further to the commercial aspects of corporate failure, there have also been concerns as to whether Director's have met their professional and legal duties under the Corporations Act, whether that involves adequate disclosure or discharging duties with appropriate levels of care and skill.

External to the company, and yet equally responsible for fulfilling their professional obligations and legal responsibilities, is the responsibility and function of trustees in protecting and acting in the member's interests, the role of auditors in properly discharging their responsibilities and last but not least advisers in their role of providing appropriate advice to the client.

Recognising that each of these key parties plays an essential role in consumer protection and maintaining the integrity of the financial services industry, ASIC has taken action against a number of these key players to claim compensation for the benefit of investors.

### **a. Westpoint**

Westpoint collapsed with investors placing more than \$380 million in Westpoint related financial products, such as promissory notes, used to fund the group's development projects<sup>3</sup>. The reasons for Westpoint's failure included high levels of gearing, 'extensive delays, inappropriate and costly financial structuring, ineffective remedial action by management and inappropriate or ineffective risk management.'<sup>4</sup>

Whilst the collapse of Westpoint resulted out of commercial issues, in reviewing all avenues which ASIC could properly use its powers to recover funds for the benefit of Westpoint investors, ASIC commenced 19 actions across four categories namely the Directors, Auditor, Trustee and Financial Advisers seeking compensation for investors. A summary of issues and outcome of the actions is outlined below.<sup>5</sup>

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<sup>3</sup> <http://www.theage.com.au/business/kpmg-auditors-banned-over-westpoint-failure-20090817-enrg.html#ixzz1NWSG8ASG>;

<sup>4</sup> The liquidator's reasons for Westpoint's failures as cited in [http://www.accountingforgrowth.com.au/view\\_article.php?aid=5](http://www.accountingforgrowth.com.au/view_article.php?aid=5)

<sup>5</sup> <https://westpoint.asic.gov.au/wstpoint/wstpoint.nsf/byheadline/Summary+of+claims?opendocument>

b. **Westpoint Actions**

<b>Stakeholders</b>	<b>Action</b>	<b>Outcome</b>
<b>Directors</b>	ASIC commenced action against directors of Westpoint companies for breach of director's duties.	Former CFO is due to stand trial for allegations of making false statements. The Directors of Westpoint together with Auditor KPMG entered into confidential settlement of \$67.5m.
<b>Auditor</b>	ASIC was concerned regarding the audits performed of Westpoint companies by allegedly failing to identify issues related to the solvency of the Westpoint group. <sup>6</sup>	Three KPMG partners were banned for up to two years under an enforceable undertaking entered into with ASIC. KPMG settled with Directors of Westpoint to pay compensation as noted above.
<b>Trustee</b>	ASIC commenced proceedings against State Trustees Limited the trustee of unsecured mezzanine note issued by Market St Mezzanine Ltd, in March 2008 alleging that State Trustees breached its duty to scheme members and failed to comply with its obligations under the corporations act.	ASIC reached settlement with State Trustees Ltd for \$13.5m on behalf of Westpoint investors
<b>Financial Advisers</b>	ASIC took action against 7 AFSL's concerned that advisers did not meet their AFSL obligations.	ASIC reached settlement with five licensees for a sum +\$12m. Negotiations continue with the two remaining licensees.
<b>Estimated compensation from ASIC actions is likely to result in compensation of \$92.95m.</b>		

Source: ASIC website<sup>7</sup>

In taking action against the Directors, the Auditor, the Trustee and Financial Advisers, ASIC demonstrated that each of these key stakeholders have a very real responsibility to properly perform their respective functions, meeting their professional and legal obligations, in order to maintain the integrity of the financial services industry and mitigate client losses.

Failure to adhere to these obligations exposes stakeholders to potential legal action and claims for compensation payments.

<sup>6</sup> <http://www.theaustralian.com.au/business/westpoint-auditor-to-pay-67m-after-asic-ends-pursuit-of-kpmg/story-e6frg8zx-1225998334512>

<sup>7</sup> <https://westpoint.asic.gov.au/wstpoint/wstpoint.nsf/byheadline/home?opendocument>

## 6. Potential Sources of Loss Causation

What this also demonstrates is that client loss can be attributable to failures all along the value chain ranging from the market, directors & management, the trustee, auditors and advisers.

**Diagram 6.1 Key Stakeholders and Potentials Sources of Failure**



Set out below are examples of where a failure in the above categories could result in client losses:

- **Market Failure:** Whilst market failure is defined theoretically as an economic concept it is for the purposes of this document considered to be a major failing of asset classes or a specific sector of the market, for example sub-prime. The widespread collapses of agribusiness managed investment scheme (MIS) such as Timbercorp, Great Southern, Willmott Forests, FEA Group and the Rewards Group may suggest that this is reflective of a market failure rather just individual corporate failure.
- **Directors & Management failure:** directors failing to avoid or manage conflicts of interest (particularly with respect to related party transactions), misleading and deceptive conduct with respect to a company's finances or failure to discharge duties with due care and skill such as not disclosing material information.
- **Trustee/Responsible Entity failures:** a trustee failing to protect the interests of its scheme members. This could include failing to pursue a fund manager on behalf of scheme members for losses arising out of breaches of the corporations act, failing to act on evidence of financial concern of a product provider, or failing to prioritize the interests of the members in one scheme in a transaction against the interests of another when the trustee is the same for both.
- **Auditor failure:** Failure by the auditor to comply with Australian Auditing Standards, engaging in false, misleading or deceptive conduct with respect to a company's accounts.

- **External and Internal research failure;** can include being too slow to down-grade a rating when funds face financial difficulties or not understanding the risks associated with an underlying investment.<sup>8</sup>
- **Advice based failure:** failure to provide appropriate advice, not taking a client's personal circumstances into account or making false or misleading statements.

A failure by each of the respective key stakeholders, in meeting their professional and legal responsibilities accordingly, has the potential to result in client losses.

We are concerned that the proposed statutory compensation scheme, based on licensee misconduct, fails to identify that client losses are in fact attributable to each of the stakeholders where they fail to meet their professional and legal obligations. As such a compensation scheme which proposes to exclude losses arising out of investment failures other than through licensee conduct will not actually address the issues or mitigate client losses.

To illustrate, an outline of recent failures are listed below.

	<b>Issues</b>	<b>Stakeholders</b>	<b>Action &amp; Outcome</b>
<b>Opes Prime<sup>9</sup></b>	Corporate Collapse of Opes Prime stockbroking firm which owed clients \$585m at the time of collapse.  <i>Opes Prime on-lent shares to secured creditors (financiers) in exchange for margin loans. Opes clients had wrongly believed that the ownership of the shares were retained by the clients and not secured creditors.</i>	<b>Opes Prime &amp; Banks</b>	ASIC alleged Opes Prime had breached the Corporations Act by running an unregistered managed investment scheme which alleged involvement in the contravention by ANZ and Merrill Lynch. ASIC settlement reached between ANZ, Merrill Lynch and the liquidator of Opes Prime.  Settlement of \$253m delivered to creditors and investors in Opes Prime.
		<b>Directors &amp; ANZ</b>	ASIC also alleged breach of civil penalty provisions and sought compensation against the directors of Opes Prime and ANZ. ASIC reached settlement with ANZ. Directors of Opes Prime face criminal charges in relation to the collapse of Opes Prime.
<b>Bridgecorp<sup>10</sup></b>	Corporate Collapse of property finance company Bridgecorp,	<b>Directors</b>	Directors of Bridgecorp are facing charges for breach of the New Zealand Securities Act ( <i>note</i>

<sup>8</sup> [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep143.pdf/\\$file/rep143.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep143.pdf/$file/rep143.pdf)

<sup>9</sup> <http://www.theage.com.au/business/opes-creditors-accept-253m-settlement-20090724-dvs3.html#ixzz1NcVs8PXF>;

<http://www.asic.gov.au/asic/asic.nsf/byheadline/MR09-37+Opes+Prime%3A+proposed+settlement+and+ANZ+enforceable+undertaking?openDocument>;

<http://www.theage.com.au/business/asic-reveals-case-on-opes-prime-collapse-20110228-1bbtq.html>;

<http://www.news.com.au/business/breaking-news/anz-and-merrill-in-opes-prime-settlement/story-e6frfkur-111119053175>;

<http://www.smh.com.au/business/opes-prime-director-smith-to-stand-trial-20110311-1brdb.html>.

<sup>10</sup> <http://www.news.com.au/business/bridgecorp-crash-risks-455m/story-e6frfm1i-111113882889>;

<http://www.asic.gov.au/asic/asic.nsf/byheadline/06-287+ASIC+obtains+consent+orders+from+Bridgecorp+Finance+to+protect+interests+of+noteholders?openDocument>;

[http://www.nzherald.co.nz/finance-companies-in-freefall/news/article.cfm?c\\_id=1501786&objectid=10576539](http://www.nzherald.co.nz/finance-companies-in-freefall/news/article.cfm?c_id=1501786&objectid=10576539)



	which owed \$460m to investors. <i>Bridgecorp was involved in raising money from investors (debenture holders) to on lend to property developers. The company collapsed after it breached its trust deed and failed to repay principal due to debenture holders.</i>		<i>investors include Australian and New Zealand investors)</i>
<b>Fincorp<sup>11</sup></b>	Corporate collapse of property company Fincorp owed investors \$200m at time of collapse.	<b>Directors</b>	ASIC commenced proceedings against former directors of Fincorp for insolvent trading. These proceedings were later dropped.
		<b>Trustee</b>	Concerns were raised that Sandhurst Trustee had failed to act on 'evidence that Fincorp was in trouble almost nine months before it collapsed.' A class action against Sandhurst Trustee's was commenced alleging that Sandhurst breached its duties as trustee in failing to 'exercise reasonable diligence to ascertain whether the property of Fincorp would be sufficient to repay Fincorp note holders when those investments became due.'  A \$29m class action settlement was reached in May 2011.
<b>Westpoint<sup>12</sup></b>	Westpoint collapsed with investors placing more than \$380 million in Westpoint related financial products, such as promissory notes, used to fund the group's development projects. Estimated losses amount to \$310m.	<b>Actions taken against: Directors Trustee Auditor &amp; Financial Advisers</b>	Compensation settlement was reached with Directors, Auditor, Trustee and Financial Advisers.  Further details included in the Westpoint table above.
<b>Trio Capital (formerly Astarra Capital Limited)<sup>13</sup></b>	Concerns of Fraud, with limited evidence of investments actually made with little realisable value. Over a \$100m unrecovered. APRA appointed a replacement trustee and ASIC suspended Trio's license as fund manager.	<b>Directors</b>	ASIC investigated Trio Capital Directors suspected of criminal offences and breach of the corporations law. Action has been taken against one of the directors of Astarra Asset Management, who pleaded guilty to dishonest conduct and making false statements with respect to financial products.  The government provided \$55m of compensation to investors in APRA regulated superannuation funds which invested with Trio Capital.

<sup>11</sup><http://www.asic.gov.au/asic/asic.nsf/byheadline/07-86+Statement+on+Fincorp?openDocument>; <http://www.theaustralian.com.au/news/nation/savings-at-risk-after-fincorp-collapse/story-e6frg6nf-111113223103>; <http://www.news.com.au/asic-abandons-fincorp-pursuit/story-0-111116991647>; <http://www.slatergordon.com.au/areas-of-practice/victoria/general-legal-services/class-actions/fincorp>; <http://www.theaustralian.com.au/news/nation/savings-at-risk-after-fincorp-collapse/story-e6frg6nf-111113223103>

<sup>12</sup> <http://www.asic.gov.au/asic/asic.nsf/byheadline/09-146AD+KPMG+partners+provide+enforceable+undertakings+not+to+practice?openDocument>; <http://www.theage.com.au/business/kpmg-auditors-banned-over-westpoint-failure-20090817-enrq.html#ixzz1NWSG8ASG>; <http://www.businessspectator.com.au/bs.nsf/Article/ASIC-expects-170m-in-Westpoint-compensation-pd20110201-DN3T7?OpenDocument&src=tnb>

<sup>13</sup> <http://www.asic.gov.au/asic/asic.nsf/byheadline/Grant+of+financial+assistance+-+Trio+and+Astarra+investors?openDocument>; <http://www.smh.com.au/business/fraud-victims-get-55m-back-but-some-left-emptyhanded-20110412-1dcpn.html>; <http://www.asic.gov.au/asic/asic.nsf/byheadline/09-261MR+APRA+appoints+acting+trustee+to+superannuation+funds+operated+by+Trio+Capital+Limited;+ASIC+takes+licensing+action+against+Trio+Capital+Limited?openDocument>

<b>Storm Financial<sup>14</sup></b>	Collapse of Storm Financial Services, together with advice based failures through provision of inappropriate advice (notably fee for service based).  <i>Risky Business Model: Liquidators found the collapse of Storm Financial was inevitable as the business model relied on fees from over-leveraged investors.</i>	<b>Directors</b>	ASIC is alleging the directors breached their duties as Directors in exposing the firm to legal liability out of a business model which failed to take investor's personal circumstances into account.
		<b>Banks</b>	ASIC has launched legal actions against Storm's financiers - BoQ, CBA and Macquarie Bank  Investor class action against CBA settled for \$200m.
		<b>Financial Advisers</b>	ASIC has taken action against Storm Financial Advisers for the provision of inappropriate advice.
ASIC investigations into storm are continuing.			
<b>Rubicon International Leaders Fund (Capital Protected Series 1)<sup>15</sup></b>	Rubicon International Leaders Fund (Capital Protected Series 1) failed and the capital guarantee ceased to exist as the fund was not going to reach maturity.		The capital protection 'lapsed' when the fund was wound up.
<b>MIS Agribusiness Collapses:<sup>16</sup></b>	<ol style="list-style-type: none"> <li>1. Great Southern</li> <li>2. Timbercorp</li> <li>3. FEA Group</li> <li>4. Willmott Forests</li> </ol>		Issues relating to collapses: high debt levels, market and regulatory changes (tax sector), unsustainable business model, business reliance on future sales

Whilst Storm Financial is an example of both corporate failure and advice based failure a great deal of consumer investment loss has arisen out of investment failures arising out of corporate collapses rather than the provision of poor advice.

Bridgecorp<sup>17</sup>, Fincorp<sup>18</sup>, Rubicon International Leaders Fund<sup>19</sup>, Centro<sup>20</sup>, Trio Capital, Opes Prime etc are all examples of corporate failures rather than advice based failure. The extensive collapse of

<sup>14</sup> <http://www.smh.com.au/business/collapse-of-financial-planner-was-inevitable-20100527-whtv.html>;  
<http://www.themonthly.com.au/collapse-storm-financial-eye-storm-paul-barry-2980>;

<http://www.asic.gov.au/asic/asic.nsf/byHeadline/11-32AD%20ASIC%20bans%20former%20Storm%20financial%20adviser?opendocument>;  
<https://storm.asic.gov.au/storm/storm.nsf/byheadline/ASIC%20actions?opendocument>

<sup>15</sup> <http://www.moneymanagement.com.au/news/A-guarantee-is-no-guarantee>; <http://www.moneymanagement.com.au/news/A-guarantee-is-no-guarantee>

<sup>16</sup> <http://www.industrysearch.com.au/News/Another-forestry-firm-felled-after-MIS-operators-collapse-46645>;  
<http://www.smartcompany.com.au/financial-services-and-insurance/20100224-commonwealth-bank-makes-200-million-settlement-with-storm-customers.html>

<sup>17</sup> Bridgecorp - Corporate collapse of property finance company. Source: <http://www.news.com.au/business/bridgecorp-crash-risks-455m/story-e6frfm1i-1111113882889>; <http://www.asic.gov.au/asic/asic.nsf/byheadline/06287+ASIC+obtains+consent+orders+from+Bridgecorp+Finance+to+protect+interests+of+noteholders?openDocument>

<sup>18</sup> Fincorp: Corporate collapse of property company. Source: <http://www.asic.gov.au/asic/asic.nsf/byheadline/07-86+Statement+on+Fincorp?openDocument>; <http://www.theaustralian.com.au/news/nation/savings-at-risk-after-fincorp-collapse/story-e6frg6nf-1111113223103>.

<sup>19</sup> Rubicon International Leaders Fund (Capital Protected Series 1) failed and the capital guarantee ceased to exist as the fund was not going to reach maturity. Source: <http://www.moneymanagement.com.au/news/A-guarantee-is-no-guarantee>;  
<http://www.chriswrightmedia.com/afr-feb09-capitalprotection/2/>.

agribusiness managed investment schemes such as Great Southern, Timbercorp, Willmott Forests and FEA are further examples of corporate collapses and possibly even examples of market failure. The agribusiness MIS industry had been around for 15 years when the widespread and arguably systemic failure took place which was not picked up by the auditors, directors, the trustee or even the research firms.

## 7. Effective Compensation Arrangements

As these failures are investment failures, a statutory compensation scheme excluding loss or damage suffered from investment failure, other than as a result of licensee conduct, is not likely to address the issue of client loss.

A compensation scheme can only be effective if it adequately covers the instances and types of losses necessary to compensate clients, for example by including investment losses arising from product provider insolvency or fraud.

Whilst we do not support a statutory compensation scheme on the basis of licensee misconduct (on the basis that it does not recognize or address the actual problem), a last resort proposal which covers compensation for licensee and product provider misconduct or insolvency **and** required scheme funding into the scheme by all financial services licensees, including issuers of financial products (irrespective of whether APRA regulated or not) could be an alternative proposition worth further exploration.

Such a scheme would operate to fill the gaps within current compensation arrangements (AFSL insolvency, fraud and run off cover) and would add to existing PI/capital adequacy/APRA arrangements to mitigate against moral hazard by encouraging all participants, including product providers, to take greater responsibility for their actions to mitigate client losses and claims for compensation.

Whilst such a proposal requires further exploration, including an assessment of the costs involved with such a proposal weighed against the benefits, it has the potential to fill in the gaps within current arrangements (fraud or insolvency of advice based businesses) whilst more importantly addressing the primary cause of client investment loss that arises from corporate insolvency.

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<sup>20</sup> Corporate Collapse of Centro Properties Group . Source: <http://www.asic.gov.au/asic/asic.nsf/byheadline/09-202AD+ASIC+commences+proceedings+against+current+and+former+officers+of+Centro?openDocument>; <http://www.minterellison.com/public/connect/Internet/Home/Expertise/Areas%2Bof%2BExpertise/Insolvency%2Band%2BReconstruction/>