

Response to Consultation on compensation arrangements for consumers of financial services

Introduction

In April 2011, Richard St. John released a consultation paper entitled "*Review of compensation arrangements for consumers of financial services*" (*Paper*). The Paper examines the adequacy of arrangements for the compensation of consumers who suffer damage or incur loss as a result of misconduct by a provider of financial services. The Paper invites feedback and comments from interested parties.

This response to the Paper (*Response*) is made on behalf of Ron and Elaine Thornton in their capacities as trustees for the RADE Provident Fund (*Respondents*), which the Respondents use as a vehicle for all of their superannuation savings. This fund is a self-managed superannuation fund (*SMSF*) pursuant to the definition of SMSF under section 17A(1) of the *Superannuation Industry (Supervision) Act 1993 (Cth)* (*SISA*).

The Response therefore provides the views of the Respondents specifically in the context of their experience as trustees of an SMSF. They note that there is little comment in the Paper in relation to SMSFs and, by this Response, urge Mr St. John to consider the lack of compensation arrangements currently in place for SMSFs and the need for such arrangements.

Contents of this Paper:

- Part 1 details the Respondents' experience in attempting to obtain compensation.
- Part 2 outlines the Respondents' general comments in response to the Paper.
- Part 3 addresses some of the specific issues raised in the Paper.
- Part 4 outlines additional comments of the Respondents not raised in the Paper.

1. The Respondents' Experience

As stated above, the Respondents are trustees of the RADE Provident Fund (*RADE*), a SMSF.

In 2007, the Respondents, as a result of advice from PST Management Pty Limited (*PST*), invested their entire superannuation savings (in RADE) in the ARP Growth Fund. The ARP Growth Fund was a managed investment scheme (*MIS*) registered with the Australian Securities and Investment Scheme (*ASIC*), and marketed by the responsible entity, Trio Capital Limited (*Trio*). PST was an investment manager for ARP Growth Fund. At the same time, PST was financial adviser to the Respondents in relation to its investment in ARP Growth Fund. We understand that PST also provided financial advice to a number of other investors in ARP Growth Fund.

PST operated as an authorised representative of an Australian Financial Services Licenseholder, Wright Global Investments Pty Limited (*WGI*). Trio, PST and WGI were all registered with and regulated by ASIC.

In late 2009, Trio collapsed following an investigation by ASIC that uncovered fraudulent activities and serious misconduct by Trio and its directors. On 19 March 2010, the ARP Growth Fund was wound up by the Court on the application of its administrators. By mid-2010, Trio, PST and WGI were all in liquidation.

As a result of Trio's collapse, the Respondents lost their entire savings in ARP Growth Fund and, to date, have no idea what happened to their savings or whether they will ever get them back.

The Respondents have considered going down a number of alternative routes to attempt to recover the lost money. As an SMSF, RADE is excluded from pursuing a compensation claim under Part 23 of the SISA, however it may pursue claims under the Corporations Act or ASIC Act, sue under general law concepts of fraud and negligence, or claim under the various insurance policies held by Trio, PST or WGI. Unfortunately, in practice, it is highly unlikely that RADE will ever be able to recover any money for the following reasons:

- Trio, WGI and PST are all in liquidation;
- the liquidators have indicated that there is almost no chance of recovery via the proof of debt process;
- the insurance policies held by Trio, WGI and PST potentially exclude claims made in relation to fraudulent activity or insolvent companies making it even more difficult to claim under them and may also be affected by material non-disclosure by the insured. Furthermore, the Respondents have no access to the insurance policies, no opportunity to vet the policies' coverage and, if they wanted access, would have to commence court proceedings at their own cost in order to gain access; and
- the time, energy and cost of pursuing claims against Trio, WGI or PST deters the Respondents from commencing proceedings against the companies and / or their directors. Given that many of the pensioners involved are of an advanced age and the collapse of Trio has resulted in a financial wipe-out, they do not have the funds or the opportunity to return to the workforce to fund a claim.

In April 2011, Assistant Treasurer Bill Shorten announced that certain APRA-regulated funds that were under the trusteeship of Trio would receive compensation under Part 23 of the SISA. See the Media Release by clicking on or going to the following page:

<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/051.htm&pageID=003&min=brs&Year=&DocType=>

The package of compensation is worth approximately \$55 million and will be covered by way of levy on other regulated funds, each to pay a maximum of \$500,000. Direct investors, including SMSFs are not eligible for the compensation payment scheme since SMSFs are not covered by this scheme under Part 23 of the SISA..

It is in the context of this experience that the Respondents make the comments below.

2. General Comments in response to the Paper

The current arrangements for the compensation of SMSFs that suffer damage as a result of fraudulent behaviour of financial services providers are unlikely to result in any recovery.

While SMSFs are entitled to claim compensation under the Corporations Act, the ASIC Act or under the general law, the practical likelihood of actually receiving compensation is extremely low. This is due to:

- the fact that licensees and advisers who act fraudulently are generally insolvent by the time investors have knowledge of this;
- the low probability of recovering money from insolvent companies via the proof of debt process; and
- the time, energy and extremely high costs of commencing proceedings generally.

Furthermore, the existence of a professional indemnity insurance scheme does not necessarily mean that an SMSF will receive compensation as many such policies have exclusions for liabilities that are a result of fraud, insolvency or material non-disclosure.

For these reasons, the Respondents strongly support the establishment of a statutory compensation scheme that will include cover for SMSFs.

3. Specific Issues for Comment

Set out in this part are the Respondents' responses to some of the specific issues identified in the Paper.

3.6 The level of assurance for retail clients that claims for loss or damage will be dealt with and awards for compensation paid.

In light of the Respondents' experience as set out above, they are not assured that claims of SMSFs will be dealt with and awards for compensation paid.

3.7 The contribution of the current compensation arrangements in maintaining confidence by retail clients in dealing with financial services providers, including financial advisers, and in underpinning responsible behaviour by licensees.

The Respondents have lost all confidence in financial services providers owing to their experience. They have also lost confidence in the regulatory system and the Government in addressing the problems associated with the financial services and superannuation industries. This loss of confidence in Government is exacerbated when the Respondents consider that individuals are encouraged to fund their own retirement through superannuation and to take more responsibility for their own financial security in a regulated environment. The experience of the Respondents and others in a similar position leaves them with a sense of grievance where they feel let down by the responsible entities and regulators and gate-keepers on whom they relied and in the wake of this situation abandoned by the financial services sector who they believed were protecting them.

5.1 The nature and extent of any shortfall in the delivery of compensation under current arrangements.

The delivery of compensation under current arrangements for SMSFs is non-existent.

Instead, SMSFs are forced to consider other options such as commencing expensive private legal actions or class actions or claiming under insurance policies when they do not have the funds to pursue. In practice, these alternatives are extremely costly, timely and energy-sapping. The likelihood of recovering anything from any of them is close to zero in circumstances where the culprits are generally insolvent by the time SMSFs realise the fraud has occurred and the various exclusions that insurance companies include in their policies.

5.6 Possible arrangements to deal with claims for compensation after a licensee ceases to trade.

Where a licensee ceases to trade or becomes insolvent, it is currently unlikely in practice that an SMSF will succeed in recovering any money by either commencing proceedings or lodging a proof of debt. A statutory compensation scheme that covers SMSFs will ensure that victims of fraud will be able to recover their superannuation savings. The Respondents strongly urge Mr St. John to advise the Government that this is the best option in dealing with such situations.

5.7 *The case for additional requirements in regard to the financial security of licensees.*

In the Respondents' view, a compensation scheme is the best protection for SMSFs the victims of fraud to recover lost money. This is because currently *"the root of the problem where retail clients are unable to recover compensation from a licensee lies in the licensee's lack of financial resources. While insurance cover, where held, provides licensees with a buffer in meeting compensation claims, it does not necessarily respond in all cases or to the full extent of the claim"*¹. However, steps to include additional requirements in regard to the financial security of licensees (such as those in place in the United Kingdom) are welcomed by the Respondents as they will provide additional protection for retail clients to receive compensation.

5.8 *The merits, and key design components, of a last resort scheme to provide compensation for retail clients, including the approach to industry funding.*

A last resort scheme to protect retail clients, including SMSFs, is welcomed by the Respondents. They envisage that such a scheme will be similar to the scheme for APRA-regulated superannuation funds under Part 23 of the SISA.

In terms of funding, currently an annual "Supervisory Levy" of \$150 is payable to the Australian Tax Office by the trustees of an SMSF with the fund's annual return. The Government also recently announced that it would provide increased financial assistance to the ATO and ASIC in relation to the regulation of SMSFs. To offset this, it announced an increase to the Supervisory Levy, from \$150 to \$180, with effect from the 2010-11 income year. See the Media Release at the following page:

<http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/074.htm&pageID=003&min=brs&Year=&DocType=0>

The Respondents submit that this levy (or a variation on the same theme) should be used to reimburse compensation for fraud paid by the Government. The supervisory level of \$150 per annum has been in place for approximately 8 years and is an effective mechanism for recouping funds to compensate SMSFs.

4. Additional comments

The rationale for the policy behind having no compensation scheme for SMSFs is that *"SMSF members, as trustees for their SMSF, have direct control over their superannuation savings and are in a position to protect their own interest"*².

The Respondents do not agree with this rationale and consider that it is fundamentally flawed

Firstly, most SMSF member trustees, like the Respondents, are generally of the 'mum and dad' variety. When balanced with the extremely complex superannuation and financial services regulatory system, which is governed by dozens of legislative instruments, regulatory bodies and legal frameworks, it is clear that an SMSF member trustee has little chance of comprehending the factors that effect their superannuation savings. The Respondents, like most participants, placed their superannuation savings in the ARP Growth fund on the advice of financial advisors regulated by ASIC. This advice had nothing to do with investment strategy but was represented by the advisors as providing ease of administration and paperwork under the SMSF framework established by the Government. In this case, the Respondents found that their superannuation investment was placed in the same fund, Trio, as that of the investors who placed their investment through APRA and have subsequently received 100% compensation under Part 23 of the SIS Act.

To assume that SMSF member trustees have "direct control" of their superannuation savings is also refuted by the Respondents. With the advent of MISs, SMSF member trustees relinquish control of

¹ Paper, paragraph 5.97

² Paper, paragraph 2.96

their savings to a third party, which is an entity regulated by ASIC. They volunteer to do so, for the expertise provided by the investment manager, who for the average SMSF member trustee, provides guidance in a complex financial environment. Even a general understanding of MISs probably does not prepare them for the risk they take on when investing in MISs. The Respondents note also that MISs and their promoters and managers are government regulated.

In addition, the Respondents also note that recommended reforms to the legislation governing SMSFs set out in Chapter 10 of the *Super System Review: Final Report* dated 30 June 2010 focus on increasing Government control over the activities of SMSFs, including their permitted investment parameters. This general policy approach is not consistent with the proposition that SMSFs have direct control over their superannuation.

Conclusion

For the reasons given above, the Respondents strongly urge Mr St. John to advise the Government that:

- it is extremely distressing that there are currently no compensation arrangements for SMSFs;
- it is unlikely in practice that SMSFs the victims of fraud will recover any money lost;
- the policy rationale underlying the lack of compensation arrangements for SMSFs is fundamentally flawed;
- the Government should put in place a statutory scheme that allows SMSFs the victims of fraud to recover compensation; and
- the Supervisory Levy currently charged by the ATO to trustees of SMSFs (or a variation of such a levy) can be used to reimburse the Government for these compensation arrangements.

Thank you for this opportunity to comment on the Paper. The Respondents look forward to reading Mr St. John's further comments in relation to this area of the law.

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