Stockbrokers Association of Australia
Incorporating SDIA

Review of compensation arrangements for consumers of financial services - Consultation Paper by Richard St.John dated April 2011

Submission

Background

The Stockbrokers Association of Australia has a long-running interest in arrangements for compensation of consumers of financial services. Its members, the stockbroking firms of Australia which are **market participants**, provide services to several million consumers. We are therefore well placed to assist the current review, undertaken in the context of the Government's *Future of Financial Advice* reforms.

From 2001 onwards, we have been involved in each step of the consultations which led to the existing regime, including the contributions we made to the following reviews and draft legislative instruments:

- *Retail Client Compensation in Financial Markets – Treasury Consultation Paper* September 2001 (SDIA Submission 26 October 2001)
- *Compensation for Loss in the Financial Services Sector - Treasury Issues & Options Paper* September 2002 (SDIA Submission 8 November 2002), and
- *Compensation Requirements for Retail Clients - Proposed Regulations* November 2006 (SDIA Submission 30 November 2006).

After the financial crisis of 2007-2008, while several of our Member firms for commercial reasons have closed, been acquired or gone into administration, there is little evidence that clients entitled to compensation have not received it. Tricom Equities underwent a change in ownership and management with no client losses. Opes Prime went into liquidation. The major client claims which arose out of the Opes Prime collapse related to issues over the security of shares held as collateral for loans to sophisticated investors under scrip lending arrangements, rather than bad advice to retail clients, which is the focus of this review. Moreover, since its collapse, the law has been changed to capture and better regulate the type of business conducted by Opes Prime. Margin lending is now regulated as a financial product under the *Corporations Act*. Particular requirements are now imposed on scrip lending, now known as 'non-standard margin lending facilities' under the *Act*[1].

[1] See ASIC Regulatory Guide 219 *Non-standard margin lending facilities: Disclosure to investors* November 2010

The *Consultation Paper* takes a broad approach, and suggests that compensation arrangements may be improved by:

- improvements to professional indemnity insurance arrangements
- greater financial literacy in clients
- better financial resources of licensees, and
- a 'last resort' compensation scheme for clients who have suffered losses that are not able to be recovered from insolvent licensees.

In Summary, we commend Mr St.John for the broad approach taken in the *Consultation Paper*. It is not enough to simply address the issue of insolvency by looking at compensation. The issue needs to be addressed with regard to other measures, including financial literacy and capital requirements of licensees. In relation to the proposal for a **'last resort'** fund, any measures so far as they impact stockbrokers, must take into account our sector's excellent record in relation to client complaints and award recovery. To do otherwise would be to introduce the risk of '**moral hazard**', where less ethical sectors obtain the benefit of protection from better regulated and more ethical sectors like stockbroking. Stockbrokers have an excellent record and strong history in the area of investor protection, and should not have to subsidise less scrupulous operators.

Financial Literacy

We wholeheartedly support the approach of the review in considering improvements which, on their face, are not *directly* related to compensation. In particular, **financial literacy** is a matter of such importance that we urge the Government to escalate efforts to increase knowledge in this area. It is clear that many people who suffered loss from the types of financial disasters examined in the course of the *Storm Inquiry*[2], would not have entered into the transactions and arrangements that caused them loss if they had better understood the transactions, and the advice that they were given. We will continue to support Government in any initiatives to improve consumers' financial literacy. Such initiatives need to include measures at the secondary school level to at least introduce students to basic financial and economic concepts.

The Current Regime – Insurance

The current regime is based around Insurance. Stockbrokers are well used to this regime, having had compulsory insurance requirements long before other financial services providers. We agree that arrangements could be improved. Section 912B requires financial services licensees to have adequate compensation arrangements in place for retail clients who suffer loss due to a breach of the licensee's obligations. The commencement of s912B was deferred until 2007 to enable the Government to consider what requirements should be imposed.

[2] Parliamentary Joint Committee on Corporations and Financial Services (Cth) *Inquiry into financial products and services in Australia* - Report dated November 2009

Under the Corporations Regulations, licensees must maintain 'adequate' professional indemnity insurance, subject to ASIC's ability to approve alternative compensation arrangements. The licensee is primarily responsible for analysing its own circumstances and business operations to ensure that an adequate level of PI cover is held.

Stockbrokers' Existing Arrangements

The stockbroking industry has led the way in compensation arrangements. For many years prior to the implementation of the Financial Services Reform Act, our members have been subject to compensation requirements in excess of ASIC or legislative requirements. This existed under former ASX requirements, which are now (since the changes to market supervision in August 2010) set out in the *ASIC (ASX) Market Integrity Rules*[3]. Our Member firms who provide services to retail clients are already subject to the following requirements:

- Compulsory PI insurance requirements under ASIC (ASX) Market Rules;
- ASX liquid capital requirements, to ensure sufficient liquid funds to meet obligations. As noted in the *Consultation Paper*, capital requirements are a key aspect to ensuring compensation to clients; and
- NGF cover: Additional client protection through the National Guarantee Fund, which guarantees the completion of transactions and protects client property on insolvency or unauthorised transfer on the part of the broker.

Insurance brokers and underwriters work very closely with our members to gauge the appropriate levels of cover. A key development in recent years post-FSR has been the improvement in risk management systems in the industry[4]. Insurance brokers and underwriters are reassured by this improvement, and where this is evident, are able to offer lower premiums, often accompanied by higher excesses. Accordingly there is appropriate apportionment of risk between insurer and insured, ensuring adequate cover for the consumer.

[3] ASIC (ASX) Market Integrity Rule 2.2.1 (the successor to the previous ASX Market Rule 4.6.1) states:

> 2.2.1 Insurance requirements—Obligation to have insurance
>
> (1) Subject to Rule 2.2.2, every Market Participant must, where the Market Participant acts for any person other than itself or a Related Body Corporate, take out and maintain, at all times, a professional indemnity (or equivalent) insurance policy that the Market Participant determines (acting reasonably) to be adequate having regard to the nature and extent of the business carried on by the Market Participant in connection with its business as a Market Participant and the responsibilities and risks assumed or which may be assumed by the Market Participant in connection with that business.
>
> (2) The professional indemnity (or equivalent) insurance referred to in subrule (1) must include insurance against a breach of duty the Market Participant owes in a professional capacity, whether owed in contract or otherwise at law, arising from any act or omission of the Market Participant and its Employees.

[4] See SEGC commentary at Note 7 below

In the stockbroking industry, most brokers have excesses greater than $100,000 – in fact some have excesses as high as $250,000. This means that most firms are effectively self-insured for FOS claims. ASX did not object to this under its requirements, and neither has ASIC.

The National Guarantee Fund

The National Guarantee Fund is one of the cornerstones of investor protection in Australia. As described in the *Consultation Paper*[5], the NGF was established by stockbrokers to ensure the settlement of transactions and to protect clients from broker insolvencies and other unauthorized transfer of securities. Unlike the proposals in the *Consultation Paper* (which only apply to retail clients), it protects all investors in the market, **both wholesale and retail**. As at 30 June 2010, the Fund stood at $111m and the minimum amount it must hold has been actuarially assessed at $76m[6].

According to the Annual Reports of the Securities Exchange Guarantee Corporation[7] - the trustee of the NGF whose membership and operations lie with the ASX - after

[5] at pages 35-37
[6] Securities Exchange Guarantee Corporation *Annual Report* 2010 page 1
[7] Annual Reports of SEGC 2007-2010. In its 2007 Annual Report, SEGC reported that –

> *'…since the formation of the NGF in 1988, SEGC has received a total of 5,576 claims. Most of those claims were received in the first four years. The high number of claims in those early years resulted from seven Dealers becoming insolvent during the first three years of the NGF's operation. Information in this annual report about claims received refers to formal claims. It does not include potential claims notified to SEGC which do not result in a formal claim. In relation to the Dealer insolvencies which have occurred, a large number of potential claims were notified to SEGC, some of which were later satisfied by the relevant liquidator without the need for a formal claim on the NGF.*
>
> *…*
>
> *'Claims received since 1988 have been in respect of a total of 42 different Dealers. The number of different Dealers involved in claims received in any one year has ranged from one to nine. Some Dealers have been involved in claims received in more than one year.*
>
> *…*
>
> *'The NGF claims history may be conveniently divided into two periods:*
>
> ***'1988-1993***
>
> *During the first six years, eight Dealers became insolvent: two in the 1987-1988 financial year; three in 1988-1989; two in 1989-1990; and one in 1992-1993. A total of 5,333 claims were received. Almost all the claims in this period arose out of the insolvency of one of those Dealers, and were made under the equivalent provisions to the present Subdivisions 4.3 and 4.9 of the Corporations Regulations. Those insolvencies were largely attributable to poor management practices, back office and other inefficiencies and losses from principal trading. The failures occurred in the aftermath of the October 1987 stockmarket fall. Very few claims were made for unauthorised transfer of securities.*
>
> ***'1994-2007***
>
> *Since 1993, a number of significant improvements have occurred in ASX's settlement and transfer systems and in Dealers' practices. There has also been improved monitoring and reporting by Dealers of their **capital adequacy, and more sophisticated risk management techniques** have been adopted by Dealers and ASX clearing houses. In this period, 243 claims have been received. There has been only one Dealer insolvency affecting the NGF, which*

an initial surge after the 1987 stockmarket crash, there have only been 2 successful claims in the last 10 years, as set out in the table below:

Year	Claims Received	Claims Allowed	Disallowed Claims Appealed	Comments
2010	'a significant number'	0	0	The Claims arose from *Opes Prime* clients relating to non-standard margin lending facilities not covered by NGF. (Post balance date, 2 Appeals from disallowance were lodged.)
2009	'a number'	0	0	-
2008	1	0	0	Post balance date, 1 claim was lodged.
2007	0	0	0	-
2006	8	1	0	7 withdrawn
2005	9	0	0	1 withdrawn; 8 outstanding
2004	1	0	0	1 outstanding
2003	0	0	0	-
2002	1	0	0	130 withdrawn
2001	20	1	0	130 outstanding (from 2000); 1 withdrawn; 18 disallowed

SEGC reported in 2007 that since 1995, $948,267 had been paid out in respect of 170 claims. More than three quarters of the claims paid involved payments of less than $20,000. The 130 claims in 2002 shown above were settled for a global figure of $300,000.[8]

As SEGC has previously noted[9], the above figures reflect the improvements in management, capital adequacy and more sophisticated risk management practices across the industry from 1993 onwards.

FOS claims data

The Financial Ombudsman Service commenced operation on 1 July 2008. In 2008 it published figures for complaints received in the previous 6 months **1 Jan – 30 June 2008**. This was during the depths of the financial crisis. Remarkably, while the Service as a whole recorded a 22.8% increase in new complaints - including a 55% increase in complaints against financial planners – during that six month period

occurred in May 1995. This was responsible for all but four of the claims received in 1996 and for several of the claims received in subsequent years. Whilst there were fewer insolvencies, there was a significant increase in claims for unauthorised transfer of securities. Although it is possible for an unauthorised transfer to occur without fraud, claims have often involved allegations of fraudulent conduct, whether by a person internal or external to the Dealer which effected the transfer.' (at page 12 – emphasis added)

[8] SEGC *Annual Report* 2007 page 14

[9] See Note 7 above

there was a **23% decrease** in complaints against stockbrokers[10]. Complaints against stockbrokers comprised 10% of all new complaints.

For the financial year **2008-09** (the year of the *Storm Inquiry*) FOS recorded an overall increase of 33% in new disputes. For this year FOS did not publish complaints by service provider, but by product group, so stockbrokers were included in the figures for securities, derivatives, managed funds, margin loans, etc, together with other providers like financial planners.[11] For the financial year **2009-10** FOS recorded an overall increase of 6% in new disputes, to 17,352. This total included 1639 complaints in relation to Investments, of which **134** (or 8%) were complaints against stockbrokers. (By comparison, 58% of investment complaints were made against financial planners.)[12]

The most recent figures for complaints against stockbrokers to FOS for the calendar year ended **31 December 2010** are remarkable[13]. During 2010, **53 complaints** were received against stockbrokers, a reduction of over **55%** on the previous year 2009, when **120 complaints** were received.

These figures are even more impressive when you consider that over recent years on ASX there have been on average around 600,000 transactions in cash equities - worth around $6bn – **per day**. (While trading by retail clients accounts for around 20-30% of these figures, it is still significant.)

Therefore, on the data published by FOS, and the NGF, Stockbrokers have attracted a very low rate of client complaints and unrecoverable losses.

The Nub of the Problem? Licensee Insolvency

One of the key concerns raised in this *Consultation Paper* (and all the earlier reviews dating back to 2001) is the position of claimants in the event of the insolvency of the licensee. Usually, there will be sufficient run-off insurance cover to handle such claims, but sometimes there will be a gap, leaving claimants without recourse. While the *Consultation Paper* refers to the issue (at paragraph 5.40), no data is produced as to the extent of the problem.

We understand that the vast majority of such claims in the last few years have arisen as a result of the collapse of one product issuer, **Westpoint**, and related claims on financial planners. Prior to that, a great number of claims and insolvencies occurred in the five years 1988-1993 after the October 1987 stockmarket crash[14]. While run-

[10] Financial Ombudsman Service *Media Release* 10 December 2008
[11] Financial Ombudsman Service *Media Release* 30 September 2009
[12] Financial Ombudsman Service *2009-2010 Annual Review*
[13] See Appendix 1
[14] For this period in the late 80's and 90's, it is difficult to provide additional data on the extent to which claimants have lost their ability to recover damages. For example, in the Estate Mortgage matter, $15m of losses against an insolvent licensee were made good by a parent company. Losses in the region of $14m which arose from the activities of Retireinvest in Adelaide were covered by a large insurance company shareholder.

off cover and insurance generally has been an issue in difficult market conditions for our members in the past, we do not see a huge problem now in need of rectification.

'Last Resort' Compensation Funds

While there have no doubt been occasions where consumers who have received an award of compensation from FOS or a Court have not been paid due to the licensee's insolvency or lack of insurance, none of these occasions have involved stockbrokers. Compulsory insurance, long before the rest of the industry, higher and more specific risk-based capital requirements and tighter regulation of stockbrokers by ASX (and ASIC) have meant that all successful awards of compensation to clients have been met. This, together with the 'back-stop' protection of the NGF for losses from settlement failure or unauthorised transfer of securities, mean that the stockbroking industry already protects consumers' interests adequately.

There needs to be a compelling case for imposing an additional cost burden on the financial services industry to fund a statutory compensation system. The industry faced the additional compliance costs imposed by the FSR (particularly the additional costs of complying with retail disclosure obligations) and is now facing further costs as we move to a multi-market environment (e.g. the cost in meeting the new best execution obligation). The imposition of further costs may see a further reduction in competition as providers of retail advisory services reconsider the viability of their retail businesses. There would need to be clear evidence of systemic (unsatisfied) losses to justify an industry-wide scheme.

Moral Hazard: Cross-subsidising recalcitrant licensees

We would be very concerned if our Members were subject to a scheme that also covered less well-regulated intermediaries. Our Members are subject to strict supervision by both ASIC and ASX over all areas of their operations including client relations, financial resources, training, management and supervision. An example of the stringency of the environment in which our members operate is that ASIC (like ASX prior to August 2010) can now fine our members up to $1,000,000 for breaches of the Market Integrity Rules, including unprofessional conduct. No other sector in the retail advice industry is subject to this level of regulation.

Funding of the Last Resort Compensation Fund

On the ASIC figures quoted in the *Consultation Paper*[15], some 3700 licensees provide services to retail clients. The *Consultation Paper* cites a study commissioned by FOS which outlines a model for a Compensation Fund[16]. The funding of the Fund would be via a levy on those 3700 financial services licensees which provide services to retail clients not exceeding 1% of revenue.

[15] at page 4, paragraph 1.14
[16] PFS *Proposal to Establish a Financial Services Compensation Scheme* October 2009

As the levy would be for the benefit of consumers, not brokers and advisers, another way to address the funding issue would be to impose the **levy on consumers directly** via a small levy on contracts, like levies on insurance contracts. It would also have the benefit of being a very low rate, far less than the 1% of revenue proposed in relation to licensees.

One would hope that any levy would be able to be removed once the Fund reached the required level, based on high-level actuarial advice. This is what has happened with the NGF. At this point, the Fund (like the NGF) would become 'self-funding', able to operate and maintain sufficient levels to cover risk via the return on its investments.

If a new Scheme resulted in increased costs – noting the already rising compliance costs to our members in doing business in a difficult market - it may be further reason for licensees to exit advisory services to retail clients, thus marginalising those who most need it.

If a levy were to be imposed on licensees, not consumers as we suggest, in order to fund any new 'last resort' scheme, it would need to reflect the differing risk profiles of the financial services industry sectors. Accordingly, the **risk profile of stockbrokers** should be **very low**, thus resulting in comparatively low premiums or levies to our Members.

Once again, we commend Mr St.John for the broad approach taken in the *Consultation Paper*, looking at factors other than just compensation. Improved financial literacy of consumers and capital requirements of licensees will lead to fewer situations where compensation is required. In relation to the proposal for a **last resort** fund, any measures so far as they impact stockbrokers, must take into account our sector's excellent record in relation to client complaints and award recovery. To do otherwise would be to introduce the risk of **moral hazard,** and will encourage less ethical operators, putting consumers at risk. Stockbrokers have an excellent record and strong history in the area of investor protection, and should not have to subsidise less scrupulous operators.

Thank-you once again for the opportunity to comment on these proposals. We would be happy to discuss this matter at your convenience. Should you require any further information, please contact Doug Clark, Policy Executive on dclark@sdia.org.au

Stockbrokers Association of Australia
1 June 2011

APPENDIX 1

FINANCIAL OMBUDSMAN SERVICE
Statistics for Year ending 30 December 2010

(*Source*: Alison Maynard, Ombudsman – Investments, Life Insurance and Superannuation, FOS - Presentation to Stockbrokers Annual Conference, Sydney 27 May 2011)

DISPUTES RECEIVED AGAINST STOCKBROKERS 2010

Issues	
Advice	5
Disclosure	12
Financial Difficulty	2
FSP Decision	8
Instructions	13
Privacy & Confidentiality	1
Service	25
Transactions	21
TOTAL ISSUES	**87**
TOTAL DISPUTES *(some with more than 1 Issue)*	**53** (2009: 120)

VALUE OF THE 53 DISPUTES RECEIVED AGAINST STOCKBROKERS 2010

<$50,000	37
$50,000 - $100,000	10
$100,000 - $150,000	2
$150,000 - $200,000	2
$200,000 - $250,000	1
$250,000 - $300,000	1
TOTAL DISPUTES	**53**

DISPUTES RESOLVED AGAINST STOCKBROKERS 2010

Resolved by Agreement	64
Decision in favour of Complainant	16
Decision in favour of Broker	21
Dispute Discontinued	24
Dispute Outside FOS Terms of Reference	9
TOTAL	**134**

VALUE OF DISPUTES RESOLVED AGAINST STOCKBROKERS 2010

	Resolved by Agreement	Decision in favour of Complainant
<$50,000	42	15
$50,000 - $100,000	9	1
$100,000 - $150,000	0	0
$150,000 - $200,000	0	0
$200,000 - $250,000	1	0
$250,000 - $300,000	1	0
TOTAL DISPUTES	**64**	**16**