

Compensation arrangements for consumers of financial services - Report by Richard St. John
April 2012

Comments on Recommendations
4 July 2012

The Stockbrokers Association of Australia would like to make the following comments on the *Compensation arrangements for consumers of financial services - Report* by Richard St. John dated April 2012 (the **Report**).

In June 2011¹, we outlined our views on compensation arrangements generally in response to the *Review of compensation arrangements for consumers of financial services - Consultation Paper* by Richard St. John dated April 2011 (the **Review**).

We are pleased that in many areas, the findings and recommendations of the *Report* are **consistent** with the submissions we made last year, but would like to take the opportunity for some final comments.

Our comments on the Recommendations in the *Report* are set out in Table 1. below.

¹ Stockbrokers Association of Australia *Submission to the Review* 1 June 2011

Table 1. Comments on April 12 Report Recommendations

Recommendation	Stockbrokers Association Comments
<p>Last resort scheme Recommendation 1: Last resort scheme It would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage.</p>	<p>We agree that now is not the time to introduce a last resort scheme, and strongly endorse Mr St. John’s findings and recommendation in this regard.</p> <p>In the <i>Report</i>, Mr St John found² -</p> <p><i>7.43 A last resort scheme would have the effect of imposing on better capitalised and/or more responsibly managed licensees the cost of bailing out the obligations of failed licensees. It would not work to improve the standards of licensee behaviour or motivate a greater acceptance by licensees of responsibility for the consequences of their own conduct. It could well introduce an element of regulatory moral hazard by reducing incentive for stringent regulation or rigorous administration of the compensation arrangements.</i></p> <p>As detailed in our submission to the <i>Review</i>³, the Stockbroking industry is an example of a better capitalised sector with higher standards. Any proposal to establish such a scheme must take into account our sector’s excellent record in relation to client complaints and award recovery, otherwise it would introduce the risk of moral hazard, where less ethical sectors obtain the benefit of protection from better regulated and more ethical sectors like ours. We also showed that Stockbrokers have an excellent record of investor protection, and should not have to subsidise less scrupulous operators.</p> <p>Mr St. John put it perfectly when he stated⁴ –</p> <p><i>To put it another way, the regulatory platform for financial advisers and other licensees needs to be made more robust and stable before a safety net, funded by all licensees, is suspended beneath it.</i></p>

² *Report* page 143 paragraph 7.43

³ Stockbrokers Association of Australia *Submission to the Review* 1 June 2011, pages 2-6

⁴ *Report* page 145 paragraph 7.50

<p>Strengthen current compensation arrangements</p> <p>In any move to strengthen the regime for the protection of consumers the initial focus, in conjunction with the <i>Future of Financial Advice</i> reforms and other efforts to raise industry standards, should be on developing a more robust and effective system to make licensees responsible for the consequences of their own conduct.</p>	<p>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 <i>ASIC (ASX) Market Integrity Rules</i>⁵. Our Member firms who provide services to retail clients are already subject to the following requirements:</p> <ul style="list-style-type: none">• <i>Compulsory Professional Indemnity insurance</i> requirements (as noted above);• <i>Minimum liquid capital</i> requirements: Market Participants are subject to liquid capital rules that are in excess of normal AFS licensees' requirements, which apply at all times, with monthly and annual reporting to ASIC/ASX, to ensure that market participants have sufficient liquid funds to meet their obligations. As noted in the <i>Review</i> and the <i>Report</i>, strong capital requirements are a key feature to ensure that funds are available for compensation to clients; and• <i>NGF cover</i>: Additional client protection exists 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.
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⁵ *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.

	The above measures provide a useful model for the strengthening of compensation arrangements generally.
<p>Recommendation 2.1: Licensees to demonstrate adequacy of their insurance</p> <p>Require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs.</p>	We support this measure, noting that it is already a requirement for Market Participants under the <i>Market Integrity Rules</i> to lodge proof of cover on an annual basis, and any claims, with ASIC ⁶ .
<p>Recommendation 2.2: Licensees to hold appropriate capital resources</p> <p>More attention should be given, on a risk targeted basis and in conjunction with the level of their insurance cover, to the adequacy of licensees' financial resources to enable better management of risks and unexpected costs such as compensation liabilities.</p>	We support this measure, noting that higher capital adequacy requirements already apply to Market Participants under the <i>Market Integrity Rules</i> (and for Clearing Participants under the <i>ASX Clear Operating Rules</i>).
<p>Recommendation 2.3: A more pro-active stance by ASIC</p> <p>ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate professional indemnity insurance cover and any new requirement in regard to financial resources, and in targeting licensees who are most at risk.</p>	We support this measure, noting that ASIC is already pro-active with Market Participants in relation to capital adequacy and insurance requirements under the <i>Market Integrity Rules</i> .
<p>Recommendation 2.4: Policing the licensing system in regards to compensation</p> <p>To assist ASIC in playing a more pro-active role in administering the licensing regime with respect to compensation arrangements, consideration should be given to clearer powers to enforce standards and to sanction licensees who do not comply through:</p> <ul style="list-style-type: none"> • powers to deal with phoenix activity, both through licensees establishing new entities or by former directors who re-emerge in the industry as authorised representatives; • ability to deal with disreputable industry 	<p>We note that ASIC's power to take action against individuals was recently increased so that banning orders can be made against persons '<i>likely to breach</i>' their obligations.</p> <p>For many years we have argued for the adoption of lower level measures to protect consumers and the industry from '<i>Bad Apples</i>', namely persons who have caused loss or damage or committed lower level breaches in one licensee who move to a new firm but who escape any formal action by</p>

⁶ ASIC (ASX) *Market Integrity Rule* 2.2.3 and 2.2.4

<p>participants; and</p> <ul style="list-style-type: none"> • access to an infringement notice regime. <p>ASIC for its part should be prepared to take action in appropriate cases to enforce its published views of what is required by the licensing conditions on insurance cover or financial resources. In the event that it becomes apparent that the current legal framework provides insufficient basis for effective enforcement action, consideration should be given to clearer legislative backing for regulatory standards on the adequacy of insurance or financial resources.</p>	<p>ASIC. A very effective model operates in the United States⁷, and we will continue to argue for its adoption in Australia.</p>
<p>Recommendation 2.5.1: Compensation where licensees cease to trade</p> <p>In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business.</p>	<p>We support these measures, so far as ASIC is able to achieve from its resources.</p>
<p>Recommendation 2.5.2: Protection from unlicensed providers</p> <p>There are risks to consumers where they deal with financial services providers that:</p> <ul style="list-style-type: none"> • have a licence, but operate beyond the scope of that licence because they provide products or services that are not covered by the licence; or • should be licensed under the Corporations Act but are not, and accordingly have limited or no compensation arrangements. <p>While acknowledging the difficulties in identifying outlaw activity, the importance of concerted enforcement effort by ASIC to police the boundaries of licensed financial service activities is emphasised. In its approach to the handling of complaints about outlaw activities ASIC should be transparent and provide as much feedback to complainants as possible in order to encourage further assistance.</p>	<p>We support measures to protect consumers from ‘outlaw’ financial services operators.</p>

⁷ Under NASD Rules firms must lodge a Form U-5 when a representative terminates his/her employment. Disclosures of misconduct therein are accessible to investors (see, *BrokerCheck* on www.nasd.com).

<p>Recommendation 2.5.3: Third party rights under licensee’s insurance policy</p> <p>(a) Where a licensee (or its administrator or liquidator) does not respond to claims from a consumer or the licensee cannot be contacted after reasonable inquiry, ASIC should be able to provide the consumer with information it has about the insurance policy including the name of the insurer and the policy number...</p> <p>(b) The third party rights provisions of the <i>Insurance Contracts Act 1984</i> should be extended...to apply where a consumer cannot recover compensation awarded against the insured and there is capacity to meet that liability from the insured licensee’s professional indemnity insurance policy.</p>	<p>As these circumstances have not arisen in stockbroking, we have no comment on this recommendation.</p>
<p>Recommendation 2.5.4: Defence costs</p> <p>ASIC should give further consideration, in its approach to the adequacy of professional indemnity insurance cover, to the treatment of defence costs with a view to striking a reasonable balance between the interests of licensees and insurers on the one hand, and consumers on the other.</p>	<p>We have no comment on this recommendation.</p>
<p>Recommendation 2.5.5: External Dispute Resolution scheme processes</p> <p>Given their key role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims. Issues for consideration include: rights of review; transparency; capacity of a member to join in a proceeding other members that might be liable; cost contribution by complainants; liability standards; relevance of regulatory guidance and other operational issues.</p>	<p>We support these measures, and agree that as these forums have grown from small beginnings to the situation now where awards of up to \$280,000 can be made against our members – making their jurisdiction akin to the higher level Courts - consideration should be given to enhanced rights of review, and the ability to join other parties to the proceeding.</p>

<p>Rebalance responsibilities of licensees Recommendation 3.1: Review regulation of product issuers As a matter of strategic approach, it would be timely to review the present relatively light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach.</p>	<p>We support the strengthening of the regulation of Issuers from the current light-touch disclosure approach of the law and ASIC.</p>
<p>Recommendation 3.2: Responsibility of product issuers through EDR schemes Some rebalancing of responsibilities of product issuers and financial advisers towards retail clients could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct amongst responsible licensees. The operating rules of EDRs should be changed to enable them to make awards that recognise the proportionate liability of product issuers, financial advisers or other licensees. ...</p>	<p>We support measures that would give EDR schemes the ability to better apportion liability between issuers and licensees.</p>

Thank-you for the opportunity to comment on the *Report*. We look forward to any new developments in the compensation arrangements for retail clients. Should you require any further information, please contact me or Doug Clark, Policy Executive on dclark@stockbrokers.org.au .



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