Stockbrokers and Financial Advisers Association Limited

7 February 2020

Manager, Redress and Accountability Unit
Financial Sector Reform Taskforce
The Treasury
Langton Crescent
PARKES ACT 2600

By email: CSLR@treasury.gov.au

To Redress and Accountability Unit

COMPENSATION SCHEME OF LAST RESORT – DISCUSSION PAPER SUBMISSION BY STOCKBROKERS AND FINANCIAL ADVISERS ASSOCIATION

We refer to the Discussion Paper *Implementing Royal Commission Recommendation 7.1 – Establishing a Compensation Scheme of Last Resort* ("CSLR") issued by Treasury in December 2019 ("the Discussion Paper"). The Stockbrokers and Financial Advisers Association ("SAFAA") appreciates the opportunity to make this submission in relation to the proposals in the Discussion Paper.

As a preliminary comment, SAFAA shares the view that it is difficult to make submissions on proposals that are not detailed, and where there is little data to accompany them. In particular, where aspects such as coverage of the CSLR are not yet clear, it is difficult to make precise comment. Therefore, SAFAA's submissions are by nature general.

Key summary

- The CSLR should not be over-engineered. There should mostly not be a very large amount of money required to fund unpaid awards on an annual basis. Based on the historic data that Treasury has provided, the amount of unpaid claims per annum is in the range of $0.5 million — $5 million. A CSLR that cost $5 million a year to run in order to deal with this number and scale of unpaid awards would not be a good outcome.
- There should not be cross-subsidisation between financial sectors. Sectors that do the right thing should not have to pay for the sectors where unpaid claims arise.

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- The potential for there to be unpaid awards against Market Participants of ASX and Chi-X is extremely low, as the stockbroking sector already has in place a compensation scheme of last resort, namely, the National Guarantee Fund (NGF). Market Participants are already liable for levies to maintain the NGF. In addition, the number of investor claims in the stockbroking sector has historically been very low. For these reasons, and because of the very high capital requirements, Market Integrity Rule requirements, and PI Insurance requirements that apply to Market Participants, the potential for a Market Participant being unable to pay an award to a client by reason of liquidation is extremely low.
- By reason of the above, Market Participants should be carved out of the CSLR to the extent that the NGF already applies. If the government is minded to not allow carve-outs, in order that investors not be confused about which areas are and are not covered by the CSLR, then in the alternative, any levy on Market Participants for the CSLR should be nil. Market Participants should not be required to pay a levy to fund claims in other financial sectors which do not meet the same exacting standards as apply to Market Participants, particularly as they already pay a levy to fund any claims that may arise in their sector.
- In the extremely unlikely event that an unpaid claim does arise in relation to a Market Participant, the claim could be the subject of recoupment by an appropriate levy in one or more subsequent years against the Market Participant sector.

Exchange Market Participants

Complaints made by investors to the Financial Ombudsman Service (FOS), and now Australian Financial Complaints Authority (AFCA), against stockbrokers have historically been at very low levels.

Attached at Annexure A is a comparative table of stockbroking disputes before FOS for 2016-17 and 2017-18. These are the last statistics that SAFAA has obtained, as FOS has since been subsumed in AFCA. These show total awards made against stockbrokers of five (5) and seven (7) respectively for those years. These numbers are very low.

There have been only a very small number of insolvencies of Market Participants over the last 40 years, notwithstanding that, in that period, we have experienced the 1987 Wall Street crash; the Asian Market meltdown; and the GFC. This has been a direct consequence of the high levels of management, capital and supervision requirements applicable under the Market Integrity Rules. Market Participants are required to hold high levels of capital and are under a strict capital reporting regime.

In the event of the insolvency of a Market Participant, investors who have suffered loss may make a claim against the NGF. The NGF already is a Compensation scheme of Last Resort for Market Participants. The NGF holds in the order of $100 million.

In the event of the funds in the NGF falling below the minimum amount, Market Participants are liable to pay a levy called by the Securities Exchanges Guarantee Corporation (SEGC) to top up the NGF. Such a levy was imposed in 2019.

As a result, SAFAA submits that Market Participants should not have to fund a second compensation scheme of last resort on top of the one that they already fund. The likelihood of there being a claim by

an investor in respect of a Market Participant which remains unpaid because of the Participant having become insolvent, and which is not then paid out by the NGF, is extremely low.

We note that statistics provided by AFCA at the recent Roundtable meeting show there being one unpaid award outstanding in respect of a "stockbroker". We suspect that this case may be a mis-categorisation, as there are a number of firms which call themselves "stockbrokers", but which are not Market Participants of ASX or Chi-X, and which are therefore not permitted under the Corporations Act to use the restricted term.

If the government is not inclined for there to be a scheme which does not apply across the board, on the grounds that investors would be unclear about whether the scheme covers them or not, then in the alternative, the levies on Market Participants should be nil to very low, to reflect the low probability of the CSLR receiving unpaid claims against a Market Participant.

For this reason, SAFAA supports the CSLR administering the scheme on a sector by sector basis, or at least, treating Market Participants as a stand-alone sector. There is no difficulty or complexity in identifying the entities that fall within the class of Market Participants. It is a simple matter of obtaining the list from ASIC and/or ASX and Chi-X.

We have been advised that there may be claims of investors arising from the BBY insolvency that may not have been accepted by the NGF. It is not known to what extent any of those claims were from retail investors, or whether they related to institutional or high net worth clients, and therefore not claims that could have been lodged with the AFCA regime. If there is a class of claims that have fallen outside the NGF, then this is the type of infrequent occurrence that can be dealt with by later recovery in the way that is suggested in the following section.

In relation to BBY, there have been questions raised about how the firm's position could have gone on for as long as it did without having been detected by regulators, and the observation is made that the adequacy of PI Insurance and effective supervision by regulators are key factors which, if they are correctly done, mitigate the extent of the arrangements for last compensation schemes that might need to be put in place.

Funding arrangements

A mentioned, in the Summary, it is difficult to make submissions in the absence of any detail about what scheme is proposed.

SAFAA's fundamental position is that the CSLR should be administered in as efficient and low-cost a way as possible. If the unpaid awards in any year number less than 100 or so, then it is hard to see why the administration should require much in the way of resourcing. The purpose of a CSLR is not to adjudicate on a claim, merely to verify that it exists and falls within the scheme's terms. This is quite a simple exercise. An operation of this nature should be capable of being run with very limited staffing, and not necessarily full-time staff.

A scheme which costs $5 million per annum to run in order to pay $500K to $2 million in awards would be a bad outcome.

SAFAA's view as expressed to the Ramsay review remains that there should be fairness and equity in the funding arrangements, and that there be no cross-subsidisation between sectors. Sectors which meet high standards and which generate no unpaid awards should not be required to fund other sectors which do not meet those same standards, which are not currently subject to a compensation scheme and which generate the unpaid awards.

For these reasons, funding should be determined on a sector by sector basis. Sectors which generate unpaid awards should have to pay for those awards. Apart from fairness, this provides incentives for each sector to take collegiate responsibility for conduct within the sector.

As mentioned, it would not be fair for levies against Market Participants (if they are to come under the CSLR at all) to be high. A nil levy would be generally appropriate, barring any unusual circumstances.

Having said that, if the total cost of the administration of the CSLR and awards paid are low, and if the resulting levy if calculated on a flat per-entity basis was also low ($00's), then a flat levy is unlikely to give rise to concerns about fairness or cross-subsidisation. With levies that are low, there is little point in pursuing equity and fairness if this results in a complex funding formula or levy administration which adds significant additional cost to the scheme, and ends up causing significantly higher levies as a consequence).

Uneven years and major failures

SAFAA favours levies to be reasonably predictable and able to be budgeted, rather than significantly variable from one year to the next.

Striking levies to meet claims on-hand and to build up a small reserve gradually over a period of time is the preferable approach. SAFAA supports the build-up of a small buffer over time to provide a capital base for CSLR.

SAFAA has reservations about the CSLR being over-engineered and attempting to cater in its ongoing funding arrangements for unusual or catastrophic events which may generate an unexpected number and volume of unpaid claims. Such events are impossible to predict, and attempting to configure the scheme and calculate funding arrangements to deal with them may result in unnecessary cost and complexity of the scheme.

IN SAFAA's view, unexpected events should be dealt with if and when they occur. The CSLR should be empowered to borrow to meet one-off situations, and/or the government should contribute funding in such cases. The amounts can be recouped in subsequent year through levies etc., attempting to even out the impact of the cost over a period of time. Previous situations involving HIH and natural disasters are examples where such an approach has been used.

SAFAA also supports CLSR having the ability to spread payments to eligible claimants over a period of years, in the event of major failures, in order to manage the demands on the CSLR and even out levies.

The prevailing low interest rate environment makes it difficult to generate a meaningful return on a large $ balance in the CSLR. Tying up a large amount of capital may not be cost-effective to administer or a good use of the funds.

Governance

As mentioned, SAFAA does not support a large and costly administration for what should in most cases be a small scope of work.

Adopting a large Board may ensure wide representation of stakeholders, but would add to cost. SAFAA's preference is for a smaller structure.

Whichever form of governance is adopted, there needs to be a vehicle by which parties who are liable to pay have a voice in how the scheme is administered. This has been a major defect in the NGF, where Market Participants are liable to pay into the NGF, but have no say at all in the decisions made by the Securities Exchange Guarantee Corporation (SEGC) in the management of the NGF. The recently established Advisory Committee now includes nominees from Market Participants and affords some degree of industry voice to the SEGC.

It is essential that the CSLR adopt some mechanism, whether through representation or an Advisory Committee, that allows for the voice of those who are financially liable to pay for the scheme to have input. The CSLR should be accountable to the Minister for the way in which the scheme is run.

Conclusion

SAFAA would be pleased to provide further feedback on the structure and funding of the CSLR once further detail is known.

We would be happy to discuss any issues arising from these comments, or to provide any further material that may assist. Should you require any further information, please contact Peter Stepek, Policy Executive, on (02) 8080 3200 or email pstepek@stockbrokers.org.au.

Yours sincerely

Judith Fox
Chief Executive Officer

ANNEXURE A

Stockbroking disputes 2017-18

FINANCIAL OMBUDSMAN SERVICE AUSTRALIA

Stockbroking disputes 2017-18	Issue Count*	Dispute Count	%	Stockbroking disputes 2016-17	Issue Count*	Dispute Count	%	Variance
Number of disputes received		160				131		+22%
Number of disputes accepted		108				94		+15%
Number of disputes closed (Incl. Registration disputes)		155				132		+17%
Top 3 products for the disputes accepted				**Top 3 products for the disputes accepted**				
Shares	*77*		63%	*Shares*	*67*		64%	
Self-Managed Fund/s	*12*		10%	*Mixed Asset Fund/s*	*8*		8%	
Mixed Asset Fund/s	*8*		7%	*Self-Managed Funds*	*5*		5%	
Top 3 issue types for the disputes accepted				**Top 3 issue types for the disputes accepted**				
Instructions	*35*		28%	*Advice*	*23*		22%	
Advice	*28*		23%	*Instructions*	*20*		19%	
Transactions	*18*		15%	*Service*	*18*		17%	

Stockbroking disputes 2017-18	Issue Count*	Dispute Count	%	Stockbroking disputes 2016-17	Issue Count*	Dispute Count	%	Variance
Top 3 issues for the disputes accepted				**Top 3 issues for the disputes accepted**				
Failure to follow instructions/agreement	24		20%	Inappropriate advice	15		14%	
Inappropriate advice	16		13%	Failure to act in client's best interests	11		10%	
Unauthorised transactions	15		12%	Failure to follow instructions/agreement	9		9%	
Outcomes for closed disputes (Incl. Registration disputes)				**Outcomes for closed disputes (Incl. Registration disputes)**				
Resolved by FSP		62	40%	Resolved by FSP		44	33%	
Discontinued		20	13%	Outside Terms of Reference		30	23%	
Outside Terms of Reference		19	12%	Discontinued		14	11%	
Decision in Favour of FSP		13	8%	Negotiation		11	8%	
Preliminary View in Favour of FSP		9	6%	Decision in Favour of FSP		9	7%	
Negotiation		9	6%	Preliminary View in Favour of FSP		8	6%	
Preliminary View in Favour of Applicant		8	5%	Decision in Favour of Applicant		7	5%	
Conciliation		7	5%	Assessment		4	3%	
Decision in Favour of Applicant		5	3%	Conciliation		4	3%	
Assessment		3	2%	Preliminary View in Favour of Applicant		1	1%	
Grand Total		**155**		**Grand Total**		**132**		

*Note: A dispute can have multiple products/issues (issue count).