6 October 2022

Via upload

Committee Members
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

Dear Senators

COMPENSATION SCHEME OF LAST RESORT: FINANCIAL SERVICES COMPENSATION SCHEME OF LAST RESORT LEVY BILL 2022 AND THE FINANCIAL SERVICES COMPENSATION SCHEME OF LAST RESORT LEVY (COLLECTION) BILL 2022

The Stockbrokers and Investment Advisers Association (SIAA) (formerly the Stockbrokers and Financial Advisers Association) is the professional body for the stockbroking and investment advice industry. Our members are Market Participants and Advisory firms that provide securities and investment advice, execution services and equity capital-raising for Australian investors, both retail and wholesale, and for businesses. Practitioner Members are suitably qualified professionals who are employed in the securities and derivatives industry.

SIAA members represent the full range of advice providers from online providers providing execution-only services to full-service stockbroking. Members who provide personal advice to retail clients and deal in securities for retail clients are members of the Australian Financial Complaints Authority (AFCA) and impacted by the proposed Compensation Scheme of Last Resort (CSLR).

Thank you for the opportunity to provide feedback on the *Financial Services Compensation Scheme of Last Resort Levy Bill 2022* and *the Financial Services Compensation Scheme of Last Resort Levy (Collection) Bill 2022* (CSLR Bills).

SIAA has been heavily engaged with government in its consultations on the issue of the compensation scheme of last resort. We have provided:

- a submission to Treasury on its discussion paper in February 2020
- feedback to Treasury on the CSLR proposal paper in August 2021 (2021 Proposal Paper) (a link to that submission is here)
- a submission to this Committee in December 2021 on the *Financial Services Compensation Scheme of Last Resort Levy Bill 2021* and the *Financial Services Compensation Scheme of Last Resort Levy (Collection) Bill 2021* (the previous Bills) (a link to that submission is here), and

- evidence to this Committee on the previous Bills in January 2022.

We note that the CSLR Bills that are the subject of this inquiry are substantially identical to the previous Bills save for an increase in the sub-sector levy cap from $10 million to $20 million.

The comments we made in our submission to this Committee in December 2021 apply equally to these new Bills. Most importantly, the details of who will be levied and for what amounts are to be contained in regulations, which have not yet been made available. SIAA understands that the process of determining the amounts of levy payable by each sub-sector will involve mathematical formulas and technical detail that is best included in regulations. However, not having the regulations available makes it difficult for us to provide proper feedback to this inquiry because we do not fully understand the impact of the scheme on our members. We have therefore assumed for the purpose of this submission that the levy arrangements as detailed in the 2021 Proposal Paper are the ones that will apply, and our feedback is based on that. However, we strongly recommend that the bill not be passed until we have been able to provide feedback on the regulations as the 'devil is very much in the detail' when it comes to the way the levies will be determined. The fact that the former government had to cap the ASIC funding levy (for financial advisers) as a result of the actual levies being significantly different from modelling and ASIC's estimates shows how important it is to have access to the detail of how the levies will be determined in order to assess impact. The CSLR levy is based on the ASIC funding levy model.

Executive summary

- SIAA supports a genuine compensation scheme of last resort to address unpaid determinations awarded by AFCA to protect the interests of consumers whose claims against a financial advice firm are not met due to either misconduct or insolvency of the relevant financial firm. SIAA also supports compensation for those who are the subject of unpaid determinations for the period from the commencement of AFCA up to the start of the CSLR.
- We agree with the Explanatory Memorandum that to be a relevant AFCA determination, the determination must relate to the provision of advice or dealing in securities for a person as a retail client and that the scheme should not deal with unpaid determinations made in favour of wholesale clients.
- We are pleased to see that the operator will be a company limited by guarantee that operates as a not-for-profit and will be independent of AFCA.
- SIAA has serious concerns with the design of the CSLR which we raised with Treasury during its consultation on the 2021 Proposal Paper. Our particular concern at the time was that under the proposed design those who had zero unpaid determinations were paying for the scheme, while those most likely to have unpaid determinations were exempted from contributing to the cost of the scheme due to the application of the $1,000 minimum levy threshold. This outcome will result in moral hazard. SIAA recommends that the levy threshold set out in the 2021 Proposal Paper be abolished and the levy be applied to all leviable licensees.
- The granting of Australian Financial Services Licenses by ASIC to under-capitalised, inadequately resourced participants in the CSLR results in these entities choosing to enter

voluntary administration rather than meet their legal, regulatory and professional obligations. We note that no SIAA members have unpaid AFCA determinations, yet they will be the entities paying for the scheme. This constitutes regulatory unfairness and also creates moral hazard.

- The rationale behind the design set out in the 2021 Proposal Paper was based on data from 2016 and took no account of recent data which shows that the financial advice sector is the least likely to be the cause of unpaid determinations. Basing the design of the scheme on out-of-date data undermines any confidence that the scheme is based on regulatory principles of fairness and equity. SIAA strongly recommends that the design of the CSLR be based on current AFCA data. Despite our raising this in the 2021 consultation, current AFCA data has not been utilised.
- SIAA recommends strongly that a risk metric should be applied to the levy for the compensation scheme of last resort.
- There is an element of public good in a scheme of last resort and we consider that unpaid AFCA fees should be borne by government.
- SIAA recommends that there is some mechanism that allows for the voice of those who are financially liable to pay for the scheme to have input, whether through industry appointment to the board or an advisory committee.
- We recommend, in light of the many concerns we have raised about the fairness of the CSLR, that it be reviewed after the first two years of its operation.
- SIAA recommends that as the levy framework for the CSLR will be based on the ASIC Industry Funding Model, the regulations for CSLR not be finalised until the ASIC Industry Funding Model Review has taken place.
- The proposed government consultation on the effectiveness of PI insurance needs to take place before the CSLR legislation is passed, given its importance in clarifying the source of unpaid determinations and reduction of risk to consumers.

Key issues of concern

SIAA continues to have the following specific concerns about the proposals for the compensation scheme of last resort:

- Market Participants providing personal advice to retail clients will be subject to a levy under the scheme. Market Participants already contribute to a compensation scheme run by the National Guarantee Fund (NGF), which currently holds in the order of $100 million. Yet they are being asked to contribute significantly to the CSLR which deals primarily with the behaviour of other entities in financial services, including those which can alter their behaviour in the knowledge that others will provide the financial safety net for their risk-taking.
- Market Participants providing personal advice to retail clients also have significant capital adequacy requirements under the Market Integrity Rules. This means that the potential for a Market Participant to be unable to pay an award to a client by reason of liquidation is extremely low. **We note that AFCA has confirmed that no SIAA member has an unpaid**

determination. Yet those firms with inadequate capital adequacy which are at risk of insolvency when faced with AFCA determinations are exempt from paying for the scheme.

- The current model is not risk-based. It takes no account of different risk profiles, such as capital adequacy; number of complaints resulting in an AFCA determination that must be paid by a financial advice firm; or record of unpaid determinations. SIAA has been unable to source from Treasury data on how many AFCA determinations are unpaid; the quantum total per year; and what sectors of the industry they come from. This makes it impossible to understand if there is an actuarial foundation to the scheme.
- The application of the $1,000 minimum levy threshold as set out in the 2021 Proposal Paper creates the perverse outcome that small firms which are less likely than larger, better resourced firms to pay an AFCA determination are exempt from paying a levy, while larger firms are required to pay both their own levy and the levy of the smaller, more-at-risk providers.
- The design of the CLSR excludes recognition of ASIC's role in ensuring companies have sufficient capital adequacy and appropriate Professional Indemnity Insurance (PI insurance) to meet their internal and external dispute compensation obligations. It is vital to understand the source of unpaid determinations both to reduce the risk to consumers of unpaid determinations and clarify if the design of the CSLR is actuarially sound. We note that the previous government announced in October 2021 that it would consult on proposals to enhance the effectiveness of PI insurance in responding to compensation claims.[1] We are unaware of the progress of this consultation and are strongly of the view that it needs to take place before the CSLR Bills are passed, given its importance in clarifying the source of unpaid determinations and reduction of risk to consumers.
- The sole rationale for the current design of the scheme appears to be the use of data from the Ramsay Review of 2016. The Ramsay Review found 92 per cent of unpaid Financial Ombudsman Service determinations came from the financial advice sector. This data is several years old, however, predating the Hayne Royal Commission and subsequent reform. The fact is that stockbroking profession experiences very few client complaints. Recent complaints data from AFCA shows that for the period 2021/2022 out of the total number of 72, 358 complaints, **only 298 complaints were made against stockbrokers**. This represents a percentage of 0.41% and needs to be considered in the context of 2.3 million trades a day on ASX. In 2021/22 only six complaints were found in favour of the client and 40 were found in favour of the firm. For the previous year, complaints against stockbrokers amounted to 490 or 0.69% of total complaints. The number of complaints against our members is declining.
- The scheme will collect levies in order to pay unpaid AFCA determinations, which will be paid by entities with no connection to those unpaid fees. This creates moral hazard, whereby the entities most likely to create an unpaid determination have an incentive to indulge in moral risk, knowing that the cost of their risk-taking or bad-decision making is borne by others. That is, they can refuse to deal with client complaints in good faith or fail to pay an AFCA determination, knowing that others have to bear the cost of that unpaid

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[1] Senator the Hon Jane Hume, 'Government meets legislative commitments in response to Hayne Royal Commission', Joint media release with The Hon Josh Frydenberg MP Treasurer, 28 October 2021.

determination.

- We note that Treasury has not published a Regulation Impact Statement (RIS) that models the cost of the scheme to those to whom it applies. Given the significant concerns raised by the financial advice industry with all iterations of the legislation dealing with the scheme, the lack of a RIS is extremely disappointing.

Our detailed feedback is set out below.

Detailed comments

Lack of a risk-based design

While the 2021 Proposal Paper carved out AFLS holders who already contribute to the NGF from levies as recognition of the important role the NGF plays as a compensation scheme of last resort for Market Participants, those providing personal advice on relevant financial products to retail clients were still caught by the scheme.

Our argument about Market Participants either not being subject to the scheme or having discounted levies applied to them is a risk-based one. It is about recognition that Market Participants already have high capital adequacy requirements, Market Integrity Rule requirements and PI insurance requirements as well as the order of $100 million in the NGF (an existing compensation scheme). These combine to ensure that the potential for a Market Participant being unable to pay an award to a client by reason of liquidation is extremely low. The 2021 Proposal Paper provided no recognition of this significantly lower risk profile which would apply if the scheme was risk-based.

We note that the CSLR Bills provide for an actuarial expert to be a board member of the scheme operator. There is no reason therefore why a risk-based approach should not be used when determining levies.

We explain the factors that significantly reduce the risk of unpaid claims being made against Market Participants in greater detail below.

Low levels of complaints

The stockbroking and listed securities advice sector has an exemplary record as regards the handling of customer complaints.

Recent complaints data from AFCA shows that for the period 2021/2022 out of the total number of 72, 358 complaints, only 298 complaints were made against stockbrokers. This represents a percentage of 0.41% and needs to be considered in the context of 2.3 million trades a day on ASX. Most complaints against stockbrokers relate to large online brokers and are not complaints relating to the provision of personal advice. In 2021/22 only six complaints were found in favour of the client and 40 were found in favour of the firm. For the previous year, complaints against stockbrokers amounted to 490 or 0.69% of total complaints. The number of complaints against our members is declining.

We do not present this low level of complaints and claims made as the rationale in itself for the lower risk profile of Market Participants who provide personal advice to retail clients. Rather, we present the undisputed fact that our members have very few claims made against them as evidence of the very low risk of a claim being unpaid, particularly when considered in conjunction with other

factors detailed below. We contend that the evidence is clear that the risk for Market Participants is far lower than for other members of the financial advice sub-sector and that this lower risk profile should be factored into the design of the CSLR and levies applied to support it.

On top of that, we have evidence from AFCA that none of our members has failed to pay an AFCA determination.

Market Participants are subject to onerous capital adequacy requirements

Market Participants must comply with significant and complex capital adequacy requirements including:

- minimum capital obligations imposed on them by the Market Integrity Rules
- the requirement to manage and lodge margin each day with ASX as part of their daily settlement requirements
- provision of a monthly liquidity return to ASX
- notification to ASX and ASIC of significant professional indemnity claims
- cash flow forecasting to ensure they have sufficient cash to manage their obligations into the future.

ASX can require Market Participants to notify it of their capital position more regularly. By way of example, during the COVID-19 pandemic, Market Participants were required to report their liquid margin to ASX on a daily basis. This meant that Market Participants were monitoring their liquidity daily. These requirements ensure that at all times ASX and ASIC have visibility of their operations. This sets Market Participants apart from other financial advice providers who are not subject to these requirements.

At the moment, Market Participants that contribute to the NGF and are subject to capital adequacy requirements are liable to pay the same levy in the financial advice sector as other financial advice licensees even though their risk of failure is far lower. The benefits of the NGF and capital adequacy requirements should flow only to those who contribute to it and are subject to the requirements. At the moment, all members of the financial advice subsector benefit from the lower claims rates from Market Participants. The model set out in the 2021 Proposal Paper did not take the different risk profiles into account. Essentially, to use an insurance-based example, everyone is paying the same premium for fire insurance even though some are living in a bushfire-prone area in a timber house and others are living in the middle of a built-up area in a concrete building with fire sprinklers.

Given that insurance companies apply a risk metric to cohorts of customers and there is significant experience available to explain how this is done, it is difficult to understand why Treasury has not sought advice on how to apply risk profiles to the cohorts of those who will be funding the CSLR. In light of the significant problems associated with the ASIC funding levy, which is the model for the CSLR, our view is that it was incumbent on Treasury to seek such advice on applying risk profiles. The list of ASX participants can be found here and the list of Cboe participants can be found here — it will be easy to identify Market Participants providing personal advice to retail clients.

SIAA recommends strongly that a risk metric should be applied to the levy for the compensation scheme of last resort. It is important that any compensation scheme of last resort be actuarially sound and risk-based, otherwise those least likely to generate unpaid claims will end up funding the scheme, resulting in regulatory unfairness.

$1,000 minimum levy threshold

The $1,000 minimum levy threshold, with levies that would be paid by those firms below the threshold being re-allocated to firms whose levies are above the threshold as detailed in the 2021 Proposal Paper, is one of the most concerning aspects of the CSLR.

The 2021 Proposal Paper maintained that the purpose of the levy threshold was to prevent the imposition of small levy amounts on the smallest leviable firms within a sub-sector.

However, the application of a levy threshold resulted in an estimated three-quarters (76%) of all financial advice firms (being those firms of up to four advisers) not contributing to the levy at all once the scheme is up and running. The perverse outcome of this proposal is that small firms that are more likely to be unable to pay an AFCA determination are exempt from paying a levy, while larger firms are required to pay both their own levy and the levy of the smaller providers. This creates moral hazard.

The proposed structure of the minimum levy threshold also acts as an incentive for financial advisers to operate under their own licence as a small 'one-man' or 'two-man band' in order to avoid the levy, rather than pay the levy passed on from a larger licensee. Currently an authorised representative of a larger licensee, even if they operate their own business, would have the levy passed onto them. However, if they operate under their own license, as currently proposed, the levy would not apply to them, even though they would have a higher risk profile. This is an unintended outcome of the way the minimum levy threshold is designed.

Unfortunately, the experience that financial advisers have had with the ASIC industry funding levy will not provide them with confidence that the levy amounts will remain at a sustainable level. The Committee would be aware of the issues arising from the ASIC Industry Funding Model that have resulted in the application of a freeze on the ASIC funding levy for the financial advice sub-sector for two years, retaining it at the 2018-19 rate, as well as a government review of the funding model itself.

The levy requires a broader coverage for it to be sustainable across the financial advice sector.

SIAA recommends that the levy threshold set out in the 2021 Proposal Paper be abolished and the levy be applied to all leviable licensees. If the levy applies to 100% of leviable licensees, the levy amount per financial advice firm should decrease.

Use of out-of-date data to support design of scheme

The sole rationale for the current design of the scheme appears to be the use of data from the Ramsay Review of 2016.

The Ramsay Review found 92 per cent of unpaid Financial Ombudsman Service determinations came from the financial advice sector. This data is several years old, however, predating the Hayne Royal Commission and subsequent reform. The Financial Ombudsman Service has been replaced by AFCA, which has been in operation for four years.

As we have stated above, for the period 2021/2022 out of the total number of 72, 358 complaints, only 298 complaints were made against stockbrokers.

SIAA strongly recommends that the design of the CSLR be based on current AFCA data, which shows that the financial advice sector contributes the lowest level of complaints in the financial

services sector, which in turn will have an impact on the level of unpaid determinations arising from this sector. The levies applied to fund the CSLR should not be based on out-of-date data.

Additional levy

SIAA has concerns about the ability of the Minister to decide to levy additional funds from other subsectors, including those not prescribed as being in-scope of CSLR, to fund a shortfall in circumstances where the operator considers that expected or actual subsector outlays will exceed the subsector cap. This essentially empowers the Minister to levy Market Participants for amounts up to $250 million for claims that have been made against other subsectors. We have difficulty understanding why entities that are out of scope of the CSLR and have not contributed to the claims would be required to fund them. SIAA considers that 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.

Payment of AFCA fees

SIAA is concerned with the proposal that the scheme will pay AFCA's complaint handling fees incurred in dealing with a claim against an insolvent firm. One of the issues raised by both stakeholders and Treasury in previous consultations is the importance of keeping the scheme as streamlined and simple to operate as possible in order to reduce administrative costs. SIAA cannot understand why a scheme set up to compensate claimants of insolvent firms is collecting levies in order to pay AFCA. This appears to us to create a 'round robin' of money that is unnecessary. There is an element of public good in a scheme of last resort and we consider that unpaid AFCA fees should be borne by government.

Governance

Scheme operator/CSLR Co

There needs to be a vehicle by which parties who are liable to pay have a voice in how the scheme is to be administered. An example of how this could be achieved is the NGF. An Advisory Committee includes nominees from Market Participants and affords some degree of industry voice to the Securities Exchange Guarantee Corporation in its management of the fund.

SIAA recommends that there is some mechanism that allows for the voice of those who are financially liable to pay for the scheme to have input, whether through industry appointment to the board or an advisory committee.

We are pleased to see that the scheme operator is accountable to the Minister for the way in which it is run and will be regulated by ASIC that will issue it with regulatory requirements relating to its compliance. Our members do not want a repeat of FASEA, which was unaccountable to the Minister and stakeholders and created significant problems for the industry that the current government is now seeking to address.

Periodic reviews

We note that the compensation scheme of last resort will be reviewed every five years to evaluate the effectiveness and efficiency of the scheme. We recommend, in light of the many concerns we

have raised about the fairness of the CSLR, that it be reviewed after the first two years of its operation.

The ASIC Industry Funding Model

We note that the annual levy will be payable by those who are members of a sub-sector within the meaning of the ASIC Industry Funding Model framework and that amounts payable by individual firms will be worked out in a manner that draws on concepts in place for similar calculations. It would be fair to say, therefore, that weaknesses in the ASIC Industry Funding Model framework will flow through to the levy framework of the CSLR.

The government is currently undertaking a review of the ASIC Industry Funding Model to address the many issues that have arisen since its introduction.

One of the biggest flaws in the ASIC Industry Funding Model is that levies imposed on the financial advice sub-sector[2] are calculated according to the number of financial advisers on the financial adviser register (FAR). This model may work well when the number of financial advisers on the FAR and the amounts to be levied remain stable. However, the decline in the number of financial advisers has been precipitous. Adviser numbers on the FAR have fallen from 25, 484 in 2017 to **15,908 as at 6 October 2022.** A reduction in adviser numbers has resulted in the levy amount per adviser increasing each year in a manner that industry considers to be unsustainable and which has resulted in the former government freezing the levy amount for the 2020-21 and 2021-22 financial years and a current consultation to review the levy framework.

Financial adviser numbers are also expected to continue to fall. An article in a recent edition of *Money Management* set out a series of scenarios that resulted in:

- 12,00 financial advisers in 20 years' time
- 6,000 financial advisers in 20 years' time
- less than 5,000 financial advisers by 2029
- zero financial advisers in five years time[3].

We consider that any levy model must take into account the possibility of a continued fall in financial adviser numbers, as otherwise the current framework could result in unsustainable levies.

SIAA recommends that as the levy framework for the CSLR will be based on the ASIC Industry Funding Model, the regulations for CSLR that determine how the levies are to be calculated not be finalised until the ASIC Industry Funding Model Review has taken place.

Conclusion

We strongly recommend that the bill not be passed until we have been able to provide feedback on the regulations as the 'devil is very much in the detail' when it comes to the way the levies are

[2] Licensees that provide personal advice to retail clients on relevant financial products.

[3] Laura Dew, How many advisers could we see in 20 years? *Money Management*, 3 October 2022.

determined. We also consider that consultation on the effectiveness of PI insurance needs to take place before the CSLR legislation is passed, given its importance in clarifying the source of unpaid determinations and reduction of risk to consumers.

We also recommend that as the levy framework for the CSLR will be based on the ASIC Industry Funding Model, the regulations for CSLR that determine how the levies are to be calculated not be finalised until the ASIC Industry Funding Model Review has taken place and a RIS should be issued by Treasury modelling the cost to participants.

Finally, we recommend that the design of the CSLR needs to be reworked so that it is actuarially sound and risk-based, as otherwise it will result in regulatory unfairness and moral hazard.

SIAA is happy to engage with the Senate Standing Committee on Economics and provide whatever assistance is necessary to improve the operation of the CSLR.

If you require additional information or wish to discuss this submission in greater detail please do not hesitate to contact SIAA's policy manager, Michelle Huckel, at michelle.huckel@stockbrokers.org.au.

Yours faithfully

Judith Fox
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