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Email: CSLR@treasury.gov.au

Director
Redress Unit
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Sir/Madam

COMPENSATION SCHEME OF LAST RESORT: PROPOSAL PAPER

The Stockbrokers and Financial Advisers Association (SAFAA) 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.

Thank you for the opportunity to provide feedback on the exposure draft of the Proposal Paper on the Compensation Scheme of Last Resort.

SAFAA attended Treasury roundtables on 30 July and 4 August 2021 at which we provided member feedback. SAFAA also provided a submission to Treasury on the discussion paper on 7 February 2020. A link to that submission is here.

Executive summary

SAFAA supports a compensation scheme of last resort. However, we have concerns with the way the scheme has been designed. While we support an efficient and streamlined structure, there are some fundamental problems with the scheme which we consider will lead to moral hazard. It is important that any compensation scheme of last resort be actuarily sound and risk-based, otherwise those least likely to generate unpaid claims will end up funding the scheme. This will result in regulatory unfairness.

Key issues of concern

SAFAA has 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 should not be leviable under the compensation scheme of last resort as the National Guarantee Fund (NGF), and requirements under the Market Integrity Rules, including capital adequacy requirements, mean that the potential for a Market Participant to be unable to pay an award to a client by reason of liquidation is extremely low.

- The current model does not take different risk profiles into account. A risk metric must be applied to the levy to ensure that the failures of the ASIC industry funding levy are not repeated.
- The scheme will be collecting levies in order to pay unpaid AFCA fees. We consider that unpaid AFCA fees should be borne by government, not by entities with no connection to those unpaid fees.
- AFCA determinations in favour of wholesale clients have the potential to undermine the sustainability of the model. It is important that AFCA 'stays in its lane' when determining complaints. Provision should be made in the AFCA rules that as part of its regard of all the circumstances of the case, it must not take into account the existence of the scheme.
- The application of the $1000 minimum levy threshold 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 proposed governance structure incentivises CSLR Co to make payments to AFCA for its unpaid complaint handling fees and creates a conflict of interest.
- Those who are liable to pay must have a voice in how the scheme is to be administered.
- CSLR Co must also be accountable to the Minister. We do not want a repeat of FASEA, which has been unnacountable to the Minister and stakeholders and created significant problems for the industry.

Our detailed feedback on the Proposal Paper is set out below.

Detailed comments

Scope

Financial products or services in-scope

SAFAA notes that a participant in a clearing and settlement facility, a large futures exchange or a large securities exchange is not a leviable licensee as regards the securities dealing levy category. We understand that this decision reflects the fact that Market Participants already have in place a compensation scheme of last resort, namely the NGF. As SAFAA has pointed out to Treasury before, in the event of a market insolvency of a Market Participant, investors who have suffered loss may make a claim against the NGF. The NGF currently holds in the order of $100 million. We welcome the carve-out for AFLS holders who already contribute to the NGF from levies under the proposed compensation scheme of last resort as recognition of the important role the NGF plays as a compensation scheme of last resort for Market Participants.

We note however that Market Participants providing personal advice on relevant financial products to retail clients fall within another sector that is subject to a levy based on the number of financial advisers on the FAR. SAFAA has previously argued that Market Participants should not be leviable under the compensation scheme of last resort at all. Our position has not changed and we repeat our arguments here.

We note the government's view that because the monies in the NGF are not claimable by consumers claiming for advice, licensees providing personal advice to retail clients should not get the benefit of the NGF. However, our argument is not that the NGF will respond to those types of claims but that the NGF together with high capital adequacy requirements, Market Integrity Rule requirements and PI insurance requirements that apply to Market Participants mean that the potential for a Market Participant to be unable to pay an award to a client by reason of liquidation is extremely low.

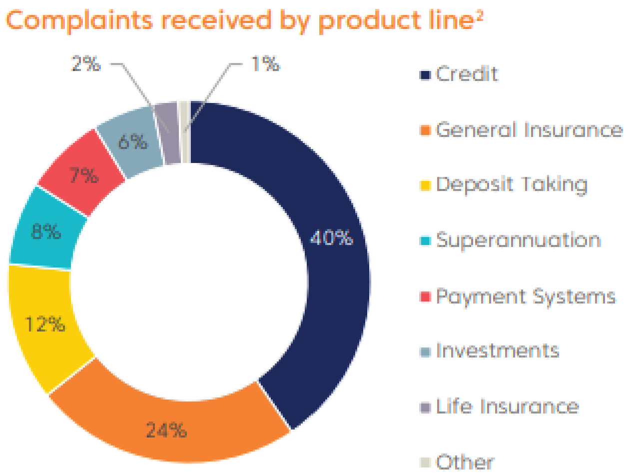
We explain the factors that significantly reduce the risk of unpaid claims being made against Market Participants in greater detail below.

Low levels of complaints

The stockbroking and listed securities advice sector has an exemplary record as regards the handling of customer complaints. AFCA's complaint statistics for the period 1 October 2019 to 30 September 2020 evidenced that out of a total of 80,833 complaints received during that period, only 4,595 complaints related to investments and advice. Of this number, only 488 complaints (or 0.6%) were made against stockbrokers.

AFCA's recent complaints report for the period 1 July 2020 to 30 June 2021 shows that of the 70,510 complaints received during that period only 6% related to investments.

AFCA's graph from that report is reproduced below:



While we understand the point made by Treasury at the roundtables that the important statistic is not the level of claims made, but the level of claims unpaid, the fact that our members have very few claims made against them means that the risk of a claim being unpaid is far less than for other members of the subsector.

No SAFAA member has failed to pay an AFCA determination

SAFAA has made enquires of AFCA. 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 last year, 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. SAFAA recommends that Treasury engages with the ASX to ensure it has a thorough understanding of these obligations.

The levy is currently not risk based

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 current model does not take the different risk profiles into account. Essentially, to use an insurance based example, everyone is paying the same premium for fire insurance eventhough 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.

SAFAA has continually argued for a risk metric to be applied to the ASIC industry funding levy so that it more accurately reflects the firms that are generating the enforcement and supervisory work. We also recommend that a risk metric be applied to the levy for the compensation scheme of last resort to ensure that the failures of the ASIC industry funding levy are not repeated. It is important that any compensation scheme of last resort be actuarily sound and risk-based otherwise those least likely to generate unpaid claims will end up funding the scheme, resulting in regulatory unfairness. We note that Treasury argued at the roundtable the importance of not over-complicating the scheme with carve-outs that will only lead to increased operational costs. The identity of Market Participants is publicly available and easy to access. For example, the list of ASX participants can be found here and the list of Chi-X participants can be found here. We do not consider that it would be onerous to change the way the levy is structured to exclude Market Participants from the scheme.

Paying claims

Payment of AFCA fees

SAFAA 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 is the importance of keeping the scheme as streamlined and simple to operate as possible in order to reduce administrative costs. SAFAA 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. Making firms with no unpaid complaints pay for AFCA's unpaid complaint handling fees is akin to making all restaurant customers pay the bill of those who have 'done a runner'.

Funding the scheme

Levy framework

SAFAA has serious concerns with the proposed levy framework as approximately 75% of levies will be collected from licensees that provide personal advice on relevant financial products to retail clients.

SAFAA has called for the government to provide details of the unpaid determinations in order to ascertain what type of firms are causing the problems; however, those figures have not been provided to date. As personal advice licensees will be funding the lion's share of the scheme, it is important that these figures be made available. Treasury advised that these figures were confidential, yet AFCA had no hesitation in advising us that no SAFAA member had failed to pay a determination.

Of concern to us is that the levy framework used for the scheme will align with the ASIC industry funding levy. We have set out our issues with the ASIC funding levy throughout this submission. A levy framework that is not risk-based will not result in a fair levy.

AFCA

We note that the review of AFCA was discussed during the roundtables and we provided Treasury with our submission to the AFCA review team that highlighted the concerns we have with the operation of AFCA. A link to our submission is here.

There are some issues that we raised in the AFCA review that impact on the operation of the compensation scheme of last resort that we wish to bring to Treasury's attention.

Of particular concern to SAFAA members is that AFCA accepts claims from wholesale clients. SAFAA has sought clarification that AFCA does not have jurisdiction to hear complaints from wholesale clients and has asked for wholesale client complaints to be a mandatory exclusion. We await the report from the AFCA review team on this issue. Accepting wholesale client complaints will not only impact on the operation of AFCA and its member firms. It also has the potential to impact the compensation scheme of last resort if AFCA determinations brought by wholesale clients are unpaid and are referred to the scheme. We note that the compensation scheme of last resort will not have the ability to reassess the merits of the AFCA determination. This means that the scheme will be required to pay an unpaid determination brought by a wholesale client, even though the compensation scheme of last resort is meant to compensate retail not wholesale clients. This would be an unfair result for firms required to contribute to the scheme and highlights the importance of AFCA 'staying in its lane' lest its determinations undermine the sustainability of the model.

Another issue of concern raised during the roundtable was whether AFCA officers dealing with a complaint against an insolvent firm would take into account the availability of funds under the scheme as part of their consideration of the principles of fairness. We consider that it is important that provision be made in the AFCA rules that as part of its regard of all the circumstances of the case, AFCA must not take into account the existence of the scheme.

$1000 minimum levy threshold

The proposed $1000 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, is one of the most concerning aspects of the proposed compensation scheme of last resort.

The proposal paper states that the purpose of the levy threshold is to limit the administrative costs of the compensation scheme of last resort and its impact on leviable firms by only charging a levy where its level is material, thus preventing the imposition of small levy amounts on the smallest leviable firms within a subsector.

However, the application of a levy threshold results in an estimated 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 which 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 small 'one-man' or 'two-man bands' 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 appy 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. ASIC's levy estimate under the industry funding model for the 2020/21 year for the financial advice sector is an amount of at least $1,500 plus $3,138 per financial adviser for FY 2020-21, an increase of $712 from the previous financial year. This increase comes on top of an increase of 160 per cent in the two years to 2019-20 and is coupled with a sustained reduction in the number of financial advisers across which this cost can be recovered. As was pointed out at the roundtables, if the number of financial advisers continues to decline (which is expected), the levy amount will increase (all things being equal), creating a pro-cyclical death spiral for levy costs.

ASIC has been engaging with industry on how to improve the affordability of advice to consumers and we consider that the proposed model for the scheme levy runs counter to that aim.

Our members are subject to an increasing level of costs including:

- ASIC industry funding levies
- ASX fees
- AFCA membership levies
- National Guarantee Fund levies
- Costs of FASEA educational requirements.

They are also subject to increasing legal, compliance and information technology costs of implementing legal reforms including forward fee disclosure; breach reporting and remediation; reference checking and information sharing; and Design and Distribution Obligations. Many of these reforms require system changes and IT spends as well as staff training. In addition, Market Participants are incurring significant costs in preparing for CHESS replacement.

The levy requires a broader coverage for it to be sustainable across the financial advice sector. We recommend that the levy threshold be abolished and the levy be applied to all leviable licensees. If the levy applies to 100% of leviable licensees, the levy amount should hopefully decrease. As the levy is based on the ASIC industry funding levy model and will be issued by ASIC to licensees, we recommend that ASIC include a separate line item for the levy for the compensation scheme of last resort in its industry funding levy invoice. This should reduce administrative costs.

Funding streams

SAFAA 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 sub-sectors. 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. SAFAA 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.

Administration costs

We note that annual administration costs are estimated at $3.7 million; establishment costs are estimated at $6.3 million; and the scheme is expected to pay out approximately $4.4 million per year.

SAFAA repeats the points it has made previously that the compensation scheme of last resort should be administered in as efficient and low-cost way as possible. It is also important that there are incentives to keep administrative costs down. We are concerned that a scheme that is totally industry-funded does not have any rigour or incentive to keep costs to a minimum because any cost increases simply flow through to industry. The ASIC industry funding levy is an example of such a scheme. A point raised at one of the roundtables was that government contribute a portion of the funding to inject some rigour into the scheme costs. We consider that this is a sensible suggestion and that Treasury should consider this in more detail.

Governance

Scheme operator/CSLR Co

We note the government's proposal that CSLR Co will be a subsidiary of AFCA Limited and will pay AFCA's complaint handling fees when AFCA incurs costs in assessing and making decisions in relation to the resolution of complaints against insolvent financial firms – even when a decision is made in favour of the firm. SAFAA has serious concerns about the conflict of interest resulting from this governance structure that incentivises CSLR Co to make payments to AFCA for its unpaid complaint handling fees. SAFAA is particularly concerned that a compensation scheme of last resort, set up to make awards to consumers who are out of pocket due to the insolvency of the relevant firm, is being used to pay AFCA's complaint handling fees. While ever the scheme requires CSLR Co to make payments to AFCA to refund it for unpaid complaint handling fees, a conflict of interest for the directors of both AFCA and CSLR Co will exist where CSLR Co is an AFCA subsidiary.

SAFAA recommends that if the government proceeds with its proposal that CSLR Co pay AFCA for unpaid complaint handling fees, representatives of industry be appointed to the board of CSLR Co to assist with managing this conflict of interest.

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 to be administered. An example of how this could be achieved is the NGF. A recently established 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. SAFAA recommends that there is some mechanism, whether through industry appointment to the board or an advisory committee that allows for the voice of those who are financially liable to pay for the scheme to have input. The scheme must also be accountable to the Minister for the way in which it is run. Our members do not want a repeat of FASEA, which has been unaccountable to the Minister and stakeholders and created significant problems for the industry.

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. The continuous disclosure legislation that has recently passed the Parliament provides for a review to be undertaken in two years' time. We recommend, in light of the many concerns we have raised about the fairness of the compensation scheme of last resort, that it be reviewed after the first two years of its operation.

Conclusion

SAFAA is happy to engage with Treasury and provide whatever assistance is necessary to improve the operation of the compensation scheme of last resort.

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

Kind regards

Judith Fox
Chief Executive Officer