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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 2021 AND THE FINANCIAL SERVICES COMPENSATION SCHEME OF LAST RESORT LEVY (COLLECTION) BILL 2021

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.

Our member firms 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 2021* and *the Financial Services Compensation Scheme of Last Resort Levy (Collection) Bill 2021* (CSLR Bills).

Executive summary

- SAFAA 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. SAFAA 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 in response to concerns about the governance of the scheme operator, it will no longer be a wholly owned subsidiary of AFCA but a company limited by guarantee that operates as a not-for-profit.

- However, SAFAA has serious concerns with the design of the CSLR which we raised with Treasury during its consultation on the CSLR Proposal Paper (Proposal Paper) in August 2021. 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. SAFAA pointed out at the the time that this outcome would result in moral hazard.
- Unfortunately, the details of who will be levied and for what amounts will be contained in regulations, which have not been made available. We understand that the process of determining the amounts of levy payable by each subsector will involve mathematical formulas and will involve technical detail that is most appropriately included in delegated legislation and that flexibility to prescribe these formulas in regulations is required as different subsectors will require different methods, formulas and/or metrics that are appropriate for each of them. However, not having the regulations available makes it difficult for us to provide feedback because we do not fully understand the impact of the scheme on our members. For the purpose of this submission we will assume that the levy arrangements detailed in the Proposal Paper apply and we will provide our feedback accordingly. However, we 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 determined.
- Moreover, the rationale behind the design is based on data from 2016 and takes 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.
- Finally, the design of the scheme as set out in the proposal paper was neither actuarially sound nor risk-based. This should be the foundation of any compensation scheme of last resort.

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 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 SAFAA 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. SAFAA was 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 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 Minister is on record as saying that "To ensure that the CSLR truly operates as a scheme of last resort, the Government will also consult on proposals to enhance the effectiveness of professional indemnity insurance in responding to compensation claims".[1] However, SAFAA is strongly of the view 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.

- The sole rationale for the current design of the scheme appears to be the use of data from the Ramsay Review of 201. 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. Data from the AFCA 2020/2021 Annual Review 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 and advice. AFCA has advised SAFAA that of this number, only 490 complaints were made against stockbrokers. This represents 0.69% of AFCA's total complaints for the 2020/2021 financial year. To place this complaints figure into context, during the month of November 2021 alone there were, 37, 455, 695 equity trades on the ASX.

- 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 determination.

Our detailed feedback is set out below.

Detailed comments

Lack of a risk-based design

While we appreciate 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

[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

compensation scheme of last resort for Market Participants, those providing personal advice on relevant financial products to retail clients are captured by the CSLR.

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 CSLR currently provides 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.

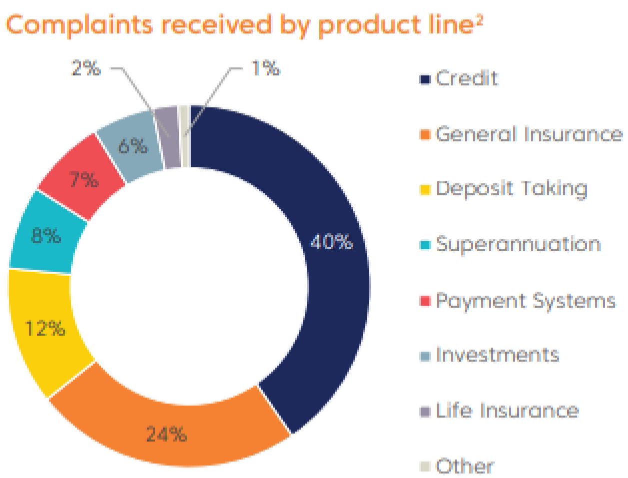
We explain the factors that significantly reduce the risk of unpaid claims being made against Market Participants in greater detail below.

Low levels of complaints

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

Data from the AFCA 2020/2021 Annual Review shows that of the 70,510 complaints received during that period only 6% related to investments and advice.

AFCA's graph from AFCA's Annual Review is reproduced below:



Of this, 490 complaints, representing only 0.69% of total complaints, were made against stockbrokers.

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 subsector 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 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.

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.

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. The list of ASX participants can be found here and the list of Chi-X participants can be found here — it will be easy to identify Market Participants providing personal advice to retail clients.

SAFAA 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 Proposal Paper, is one of the most concerning aspects of the CSLR.

The government maintains that the purpose of the levy threshold is to prevent 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 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 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. 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. This is coupled with a sustained reduction in financial adviser numbers across which costs must be recovered. According to Wealth Data there are 18,572 advisers as of 9 December 2021(down from almost 29,000 in 2018).

The cost increases became so unsustainable that the government announced earlier this year that it would cap the ASIC funding levy for two years, retaining it at the 2018-19 rate. Moreover, the charge made against the ASIC funding levy model is that the financial advice sector is paying for enforcement against other subsectors.

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

SAFAA recommends 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 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 three years.

As we have stated above, of the 70,510 complaints received by AFCA in the financial year ending 30 June 2021, only 6%involved financial advice and investments and only 490 of those complaints (representing 0.69% of total complaints) were made against stockbrokers.

SAFAA 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

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 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. 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.

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'.

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. 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 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 now 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 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

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 determined. We also contend 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.

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.

SAFAA is happy to engage with the Senate Standing Committee on Economics 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