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Ms Ruth Smith
Financial System Division
The Treasury
Langton Crescent
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Dear Ruth,

Submission in response to the issues and options paper concerning compensation for loss in the financial services sector

Thank you for the opportunity to make a submission on the issues and options paper.

We note that this is the first stage in the Government's consultation process and that, after considering initial submissions, you intend to expose for further comment a more detailed proposal. We look forward to reviewing this proposal and, in due course, providing you with a further more detailed submission.

Executive summary

1. Many of the potential reforms identified in the issues paper are significant and, if implemented, would involve substantial changes to current arrangements. We therefore believe that it is necessary to proceed with caution and, if necessary, implement any changes in stages. When the government has finally decided its policy direction, further detailed consultation on implementation of the reforms will be required.
2. There is justification for requiring, through legislation, compensation arrangements in the financial services sector for losses suffered by clients as a consequence of (mis)conduct of financial services licensees.
3. Responsibility for having relevant compensation arrangements should ultimately rest with the financial services licensee (whose conduct causes the loss).
4. Financial services licensees should be required to have professional indemnity insurance or an equivalent such as self insurance.
5. Risk management is critical for any scheme operator. Claims should be capped. Claimants should be limited to retail clients. Alternatively, claims could be made by both retail and wholesale clients provided that they were subject to retail level caps.
6. The NGF should not be provided as "seed funding" for any broad statutory scheme (if this is the government's position). There is a need to recognise existing arrangements and equity issues for existing funds. Ongoing scheme funding could be provided from trust account interest and levies. If funding was to be provided by levies, those levies should be subject to monetary caps.
7. FIDA type funding should continue to be available for industry development to the extent of continuing surplus of funds.
8. There are arguments for moving, over time, to minimum and uniform standards for claims coverage eg coverage for a licensee's insolvency. If this was the government's position though, it would require careful consideration and a significant transition from existing arrangements.

Requiring compensation arrangements in the financial services sector is justified

There is justification for requiring, through legislation, compensation arrangements in the financial services sector for losses suffered by clients as a consequence of (mis)conduct of financial services licensees.

Financial services are critical to all consumers. It is important that consumers retain confidence in the market place for the provision of financial services in order to ensure their continued participation in it. Requiring compensation arrangements in the financial services sector is the best way to achieve this outcome.

This is not to say that consumers should not bear any risk. In our view it is important that they do. This can be achieved through various mechanisms such as capping arrangements.

Responsibility should ultimately rest with financial services licensees

Responsibility for having relevant compensation arrangements should ultimately rest with the financial services licensee (whose conduct causes the loss). Financial services licensees should be so liable because it is their conduct that has caused the loss to the consumer. Imposing responsibility on licensees will give them an incentive to ensure that they have appropriate risk management practices in place to minimise the risk of liability.

The need for professional indemnity insurance

Financial services licensees should be required to have professional indemnity insurance or appropriate self insurance arrangements. Licensees should be able to choose which alternative suits their circumstances.

Regulatory oversight is necessary to ensure that appropriate cover has been obtained and maintained. In relation to ASX Participating Organisations, this oversight is currently provided by ASX under its operating rules. We understand that for some licensees (eg insurance brokers) oversight is provided by ASIC. In the interests of ensuring uniformity amongst all licensees, we believe that it would be more appropriate for the oversight role to be centralised and performed by ASIC as part of the licensing regime for all licensees rather than for it to be regulated by the operating rules of market operators. The operating rules would, however, still have a significant role to play in requiring participants to disclose such things as actual and potential claims so that ASX could appropriately address risk management issues.

The issues paper notes that before the Government develops policy in this area, it requires further information about the current state of the market for professional indemnity insurance in the financial services sector. We set out below some observations regarding this matter so far as ASX Participating Organisations are concerned.

Participating Organisations must take out and maintain at all times insurance of a kind and for an amount that a reasonable person would determine to be adequate having regard to the nature and extent of the business carried on by the Participating Organisation. If the Participating Organisation acts for any person other than itself or a related body corporate it must take out professional indemnity insurance against a breach of duty it owes in a professional capacity (ASXBR 5B.6.1).

Participating Organisations must also provide ASX with a copy of the certificate of insurance, details of the amount of cover and notify the Exchange of any claim or circumstance which is likely to give rise to a claim (Rules 5B.6.3 and 5B.6.4). If the professional indemnity insurance policy is amended, cancelled or partially cancelled, the Participating Organisation must notify the Exchange immediately, in writing (Rule 5B.6.5).

The above arrangements ensure that ASX is kept up to date on an on going basis with any liability or potential liability and the accounts and financial position of a Participating Organisation are accurately reported as required under ASX Business Rule 1A.2.10.

ASX has recently undertaken a review of Participating Organisations' insurance requirements. This review has been undertaken in light of recent ASX experience where many Participating Organisations experienced difficulties in obtaining PI cover. For example, ASX is aware that during the last round of insurance renewals, many brokers found it difficult to obtain insurance. ASX experience is that, until this year, many stockbrokers in the retail sector had insurance deductibles (or excesses) of $50,000. As a result of the insurance crisis, deductibles for many stockbrokers have increased to $100,000.

Changes in the levels of professional indemnity insurance coverage for the industry are reflected in Figures 1 and 2 below. The figures are indicative only and must be treated with some caution as they are not limited to the retail investor sector (ie they include PI coverage for institutional transactions). They also include both domestic and global policies. Nevertheless, Figure 1 clearly indicates a marked decline in the average level of PI insurance in the industry since September 2001. In some cases, PI coverage has been halved.

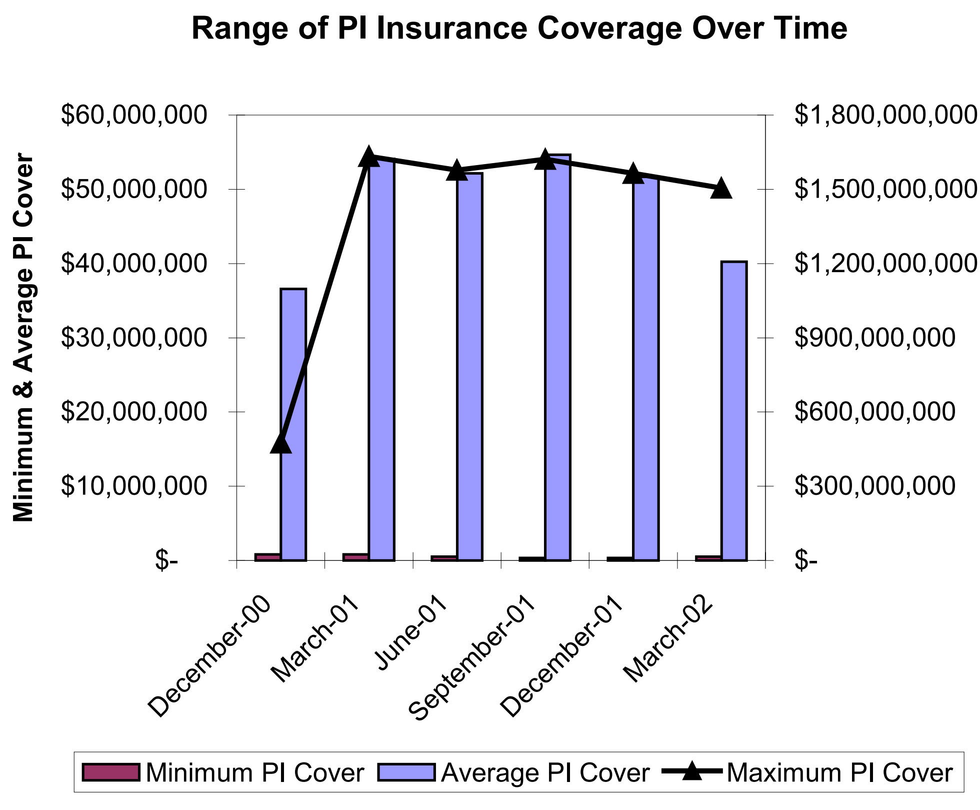

Figure 1

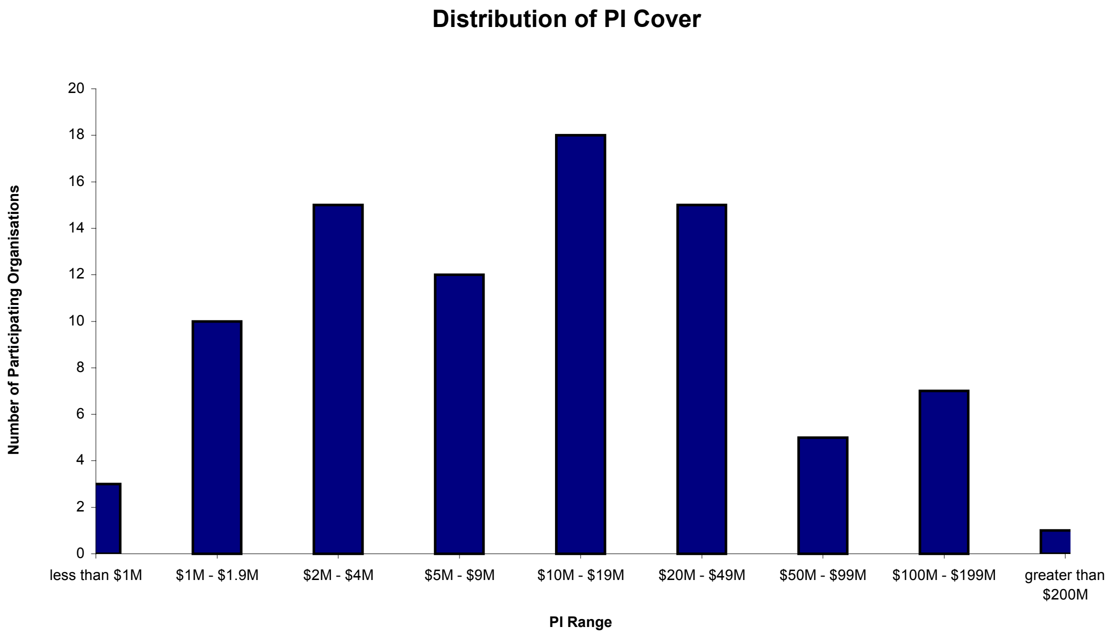

Figure 2

Capping of claims

No compensation scheme can provide full cover for all claimants in all circumstances. We therefore believe that it is unreasonable to expect that a scheme operator should be expected to face, as the NGF currently does (with one exception), the prospect of unlimited liability for claims. Capping of claims is therefore essential.

Caps are essential for a number of reasons. They are one means of addressing the moral hazard issue. They are also necessary for the practical operation of any scheme. The experience of the NGF shows how difficult it is for a scheme operator to make an actuarial assessment of the amount required in the Fund to cover its potential liabilities if claims are not capped. Capping of claims will assist the scheme operator in such an assessment. Capping will also keep the cost of any scheme within reasonable bounds for participants. This ultimately benefits investors given that costs to participants will inevitably be passed on to consumers.

Accordingly, ASX supports SEGC's submission that claims on any compensation scheme should be subject to monetary caps. Claimants should also be limited to retail clients. Alternatively, claims could be made by retail and wholesale clients provided that all claimants are subject to retail level caps.

We agree that there should be a category of excluded claimants to bar those connected with the wrongdoer (eg related parties of the licensee) or those who have profited from the wrongdoing from making a claim. How the category of "excluded persons" is defined may depend on the possible grounds for claiming loss. For example, if the wrongdoing relates to loss of property, it would be appropriate to define the category of excluded persons in the same way that it is currently done for the NGF.

Use of NGF funds

ASX is strongly opposed to NGF funds being provided as "seed funding" to be generally available for any broad statutory scheme (if this is the government's position). NGF funds should only be used for purposes consistent with the purposes for which the current statutory trust was established. Those purposes are:

1. to provide investor protection in connection with ASX trades by ASX Participating Organisations;

2. to provide clearing and settlement system support to ASX's markets; and

3. (to the extent of any excess) to provide industry development funding via FIDA.

ASX's objection to the use of NGF funds for other purposes is based on legal and equitable grounds.

It seems to us to be questionable (from a constitutional perspective) that NGF trust moneys could be appropriated and be made generally available as funding for a broad scheme. This would require legislation to effect a compulsory acquisition of a portion of the Fund, for a purpose beyond the purpose of the existing statutory trust. The difficulty of dismantling the NGF and existing fidelity funds for this purpose may be a significant obstacle to reform in this area.

There are also substantial equity and fairness issues to consider. It is inequitable that moneys accumulated by one section of the financial industry (ASX Participating Organisations and their clients) should be applied across a number of different non contributing market segments. It would therefore be inappropriate for NGF funds to be made available to satisfy claims that may involve intermediaries other than ASX Participating Organisations.

This is particularly the case given that ASX Participating Organisations are subject to strict risk management and capital liquidity requirements that other licensees are not. ASX Participating Organisations, for example, are subject to rigorously enforced prudential standards via the Business Rule 1A capital liquidity regime. These prudential standards have substantially reduced the likelihood of insolvency related claims. Other intermediaries, such as financial planners, are not subject to the same (or any) similar regime. It would therefore be inequitable to allow these intermediaries or their clients (who have not contributed to the Fund in any way) to obtain the benefit of access to NGF funds to meet claims.

This is not to say that NGF funds could not be used in some way. Depending upon the Government's preferred option, it may be possible for SEGC to make a contribution from the NGF towards any statutory scheme on behalf of ASX Participating Organisations as their initial contribution or "levy" provided that those funds were set aside for the benefit of clients trading on ASX markets through ASX Participating Organisations. In other words, it may be consistent with the purposes for which the NGF was established if some NGF funds were used as Participating Organisations' "industry" contribution to any broad scheme. In return, those Participating Organisations could receive a "contribution holiday" exempting them from the requirement to contribute to the scheme. Other intermediaries though would still be obliged to make a contribution. Once contributed, NGF funds would need to be ring fenced in some way (eg held in a sub scheme) in order to quarantine those funds from claims involving other intermediaries for the "fairness" reasons noted above.

Ongoing funding for a broad statutory scheme could then be provided from a variety of sources. One such source (which has been used to fund the NGF in the past) is interest on trust accounts. Using trust account interest would not only ensure that the scheme was industry funded but it would also mean that retail clients, who ultimately benefit from compensation arrangements, contribute to them. If this source of funding was utilised, it would be necessary to make appropriate amendments to Part 7.8 of the Corporations Regulations given that those regulations currently permit trust interest to be retained by licensees in certain circumstances.

Another source of ongoing funding identified by the issues paper is the imposition of levies. ASX believes that this funding mechanism may need to be used with caution and that it would be appropriate to cap licensees' liability to contribute to levies. The imposition of caps on levies is critical because the current uncapped liability to contribute to levies prevents some entities (eg ADIs) from participating in Australia's capital markets.

For some time, ASX has been considering a proposal to enable ADIs to become Participating Organisations. As you know, SEGC and ASX can currently impose levies on participants under ss889J and 889K of the Corporations Act. These levies are not limited in amount. Accordingly, participants potentially have an unlimited liability to pay these levies. A major stumbling block to enabling ADIs to become Participating Organisations has been APRA's concern that ADIs may potentially become exposed to an open ended commitment to contribute to the NGF. APRA's prudential standards prohibit ADIs from committing to such open ended exposures. As a result, ASX is not able to proceed with its proposal until such time as participants' potential liability to pay levies is capped.

Unless levy powers are subject to monetary limits, ADIs will be prevented from becoming direct participants of ASX's markets. ASX believes that this situation needs to be remedied and these barriers to entry removed as soon as possible.

Levies also raise important issues of cross subsidisation. It would be inequitable, for example, for one class of licensee (eg ASX Participating Organisations) to pay a levy to cover a default involving another class of intermediary (eg an insurance broker). Levies therefore need to be subject to a causation requirement so that the liability to contribute is linked to the type of default.

FIDA funding

If a new compensation regime involved compensation funds then FIDA type funding should continue to be available for industry development to the extent of continuing surplus funds.

This would allow for excess payments to be made for financial services education and other appropriate development purposes. The history of the use of FIDA funds demonstrates that these funds have been directly and indirectly used to promote significant benefits to investors and to the financial services industry over a substantial period of time. It would be unfortunate if reforms to compensation arrangements deprived the industry and future participants and investors of these benefits.

Need to proceed with caution

We note that the Government considers it desirable that any legislative reform necessary to give effect to the outcome of the current review be in place in good time before March 2004, the end of the FSR transition period.

Given the breadth of the issues raised in the paper, and depending on which particular option is adopted, the March 2004 implementation timeframe may be somewhat optimistic.

Many of the potential reforms identified in the issues paper are significant and, if implemented, involve substantial changes to current arrangements. We therefore believe that it is necessary to proceed with caution and, if necessary, implement any changes in stages. When the government has finally decided its policy direction, further detailed consultation on implementation of the reforms will be required. The length of any transition period would, of course, depend upon the exact nature of the proposed reforms.

One area which requires careful consideration so far as transition arrangements are concerned is the issue of ownership and governance arrangements for SEGC. Another is the implementation of minimum, harmonised and consistent standards for claims coverage eg limiting any broad scheme to a licensee's insolvency. There are a number of good reasons why it is desirable to have harmonised compensation arrangements across the financial services sector. Depending on the scheme adopted, it would provide simplicity and clarity for clients. For example, the distinction between equities and futures is no longer justifiable. Nevertheless, the protection currently offered by the NGF retains this distinction including coverage for equities but not futures. Compensation arrangements based on a minimum standard governing all financial products would ultimately lead to greater investor certainty.

While minimum standards have advantages, it is nevertheless important to recognise that the financial services sector is not uniform and that licensees operating in this sector are not all the same. It is therefore necessary to allow for variations to take account of different financial products, the different risks involved both by reference to financial product and licensee, the different types of licensees involved (eg those that are prudentially supervised and those that are not) and the different ways of doing business across the industry. One mechanism for dealing with these variations may be to operate a number of sub schemes under a single overarching scheme.

If harmonisation of compensation arrangements is ultimately the Government's position, then careful consideration will also need to be given to issues of costs to participants and cross subsidisation. All of these matters highlight why the Government should proceed with caution and why a significant transition period from existing arrangements may be required.

Given these matters it is difficult to reach a concluded view in relation to these issues without first understanding, in a little more detail, the Government's preferred option. Accordingly, ASX looks forward to further consultation with Treasury and the opportunity to make further submissions on this topic once the Government's likely direction has been formulated.

Yours sincerely,

Christine Jones

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General Counsel