



8 November 2002

Ms Ruth Smith  
Specialist Adviser  
Financial System Division  
The Treasury  
Langton Crescent  
Parkes ACT 2600

Dear Ruth,

**COMPENSATION FOR LOSS IN THE FINANCIAL SERVICES SECTOR  
- Issues & Options paper September 2002**

The Securities & Derivatives Industry Association represents the interests of 70 Principal Member stockbroking firms which account for over 96% of trading on the Australian Stock Exchange. SDIA would like to make the following submissions in relation to the compensation issues & options paper.

On 26 October 2001 SDIA made a submission to what was then the Companies & Securities Advisory Committee regarding its earlier enquiry into this topic (see, *Retail Client Compensation in Financial Markets* – CASAC Consultation Paper, September 2001). A copy of our submission is attached for your reference.

We note that unlike the earlier CASAC proposals, the issues & options paper addresses compensation in a much broader sense. For example, the scheme discussed in the CASAC paper only addressed claims against insolvent financial services licensees. The current paper, while considering the issue of insolvency, addresses wider issues such as compensation in general. This reflects the language of s.912B(1), which requires licensees who deal with retail clients to have

“...arrangements for compensating those persons for loss or damage suffered because of breaches of relevant obligations under this Chapter by the licensee or its representatives.”

We would like to reiterate several of our earlier points, and address some of the Principal Issues in the issues & options paper.

## 1. The Problem of Insolvency (Principal Issue 1)

One of the key concerns raised in the paper (and the earlier CASAC work) was the position of claimants in the event of the insolvency of the licensee. Usually, there will be sufficient run-off insurance cover to handle such claims, but sometimes there will be a “gap”, leaving claimants without recourse. The paper provides useful data from the NGF as to its history of claims (see paragraph 41), with the vast majority of claims and insolvencies having occurred in the five years 1988-1993. It is difficult to provide additional data on the extent to which claimants have lost their ability to recover damages due to this gap. However, we note that in the Estate Mortgage matter, \$15m of losses against the an insolvent licensee were made good by a parent company, and \$14m of losses which arose from the activities of Retireinvest in Adelaide were covered by a large insurance company shareholder. While run-off cover and insurance generally has been an issue recently for our members (see notes below on Professional Indemnity insurance), we do not see a huge problem in need of rectification.

There needs to be a compelling case for imposing an additional cost burden on the financial services industry to fund a statutory compensation system. The industry is already struggling with the compliance costs imposed by the FSR (particularly the additional costs of complying with the new retail disclosure obligations) and the imposition of further cost may see a further reduction in competition as providers of retail advisory services reconsider the viability of their retail businesses. There would need to be clear evidence of systemic (unsatisfied) losses to justify an industry wide scheme.

## 2. Existing Arrangements Sufficient?

Principal Members of SDIA who are ASX Participating Organisations are already subject to a high level of cover for retail clients. Our Principal Members must:

- have internal complaints resolution processes which conform with the Australian Standard
- be members of a complaints resolution scheme (currently FICS); and
- have compulsory professional indemnity insurance sufficient for their business (ASX Rule 5.9).

In addition, our members' financial position must be strong enough to meet rigorous ASX capital adequacy regulation standards which are higher than other non-ASX licensees. They must also meet increasingly rigorous standards of training and conduct. Absent evidence of significant losses to clients who fall in the gap, we would argue that existing client compensation requirements for our members are of a higher standard than other sections of the financial services industry, and are sufficient.

## 3. Retail v. Wholesale Claimants (Principal Issue 5)

Consistent with the requirements of s.912B, we are of the view that compensation arrangements ought only apply to retail clients.

## 4. Professional Indemnity Insurance (Principal Issue 6(a) & Attachment E)

Professional Indemnity insurance is compulsory for our Principal Members. Like other professions, our members have encountered problems with renewal of cover in the 2002 calendar year. Premiums have risen by up to 500% and Deductibles (excess) have risen by up to 300% (typically \$150,000), which has caused significant financial stress to our

members, especially in a quiet stock market. Added to these problems has been the withdrawal of participants from the insurance market. However, we are hopeful that a significant new entrant is about to appear, which may see some real competition return to the market. The end result is that the vast majority of claims may not be covered by insurance, which may be detrimental to the consumer.

#### **5. Cross subsidising less regulated licensees**

We would be concerned if our Members were subject to a scheme that also covered less well-regulated intermediaries. As discussed at 2. above, our Members are subject to strict supervision by both ASIC and ASX over all areas of their operations including client relations, financial resources, training, management and supervision. An example of the stringency of the environment in which our members operate is that ASX can now fine our members up to \$250,000 for breaches of its Rules. If a compensation scheme were extended to cover the losses caused by less well-regulated participants, entry standards would need to be high.

#### **6. Extend NGF to cover the gap?**

One possibility is to extend the coverage of NGF to cover the "gap" in cover discussed above. NGF could also be extended to licensees not currently subject to NGF coverage, for example futures brokers, subject to satisfying equivalent entry standards (see 5. above). This would have the benefit of using an existing scheme rather than creating a new one from scratch. The Scheme could overarch a network of sub-schemes for product/licensee groups such as ASX PO's, SFE Members, Financial Planners, etc. Under this model, with its cover extended to cover the insolvency "gap", the enhanced NGF would adequately cover our Members' clients. (With improvement in Stock Exchange procedures and settlement since NGF was founded, there may also be scope to increase or remove altogether the present limit to compensation at 14% of the minimum size per participant.) We note that changes to the Corporations Act on the enactment of the FSR reforms in March 2002 saw the removal of the requirement for our members to deposit a portion of their trust accounts with NGF, which was one of the main sources of funding for the scheme. However, in consultation with NGF and Treasury, SDIA worked to maintain interim funding for the scheme, which has been achieved through the new requirement to remit interest on trust accounts to the NGF (see, Regulation 10.2.20B).

#### **7. Scheme as Adjudicator and Compensator**

While on its face it would look very efficient for a Scheme to both adjudicate claims and pay compensation, we see the potential for several problems in this arrangement:

- (a) under an insolvency scenario, there is normally few staff left to properly defend claims. Accordingly claims that may not normally succeed may do so against an Insolvent licensee. It is amazing how claimants materialise in these situations. In addition it also gives claimants the benefit of early payment ahead of other creditors;
- (b) having both roles, the funding position of the Scheme may also affect its adjudications e.g. fewer successful claims if reserves were running low.

#### **8. International reputation**

While no doubt such a Scheme would do no harm to our reputation in general, direct benefits to our Members would be minimal, since our members are not greatly involved in marketing their services to offshore retail clients.

## 9. Costs and Funding of Compensation scheme ( Secondary Issue 16)

If a new Scheme resulted in increased costs – noting that Financial Services Reform and insurance is already contributing to increased costs in a difficult market - it may be further reason for licensees to exit advisory services to retail clients, thus marginalising those who most need it.

If a levy were to be imposed it would need to:

- reflect the differing risk profiles of the financial services industry subsectors;
- take into account existing supervision of the subsectors & any prudential type obligations imposed (eg ASX membership, APRA Regulation)
- take into account any existing compensation systems (eg the NGF).

## 10. Power of Appointment as Liquidator

We note that in the US, stock exchanges report to S(ecuritie) P(rotection) I(nvestor) C(orporation) on members in or approaching financial difficulty and that SIPC may apply to the Federal Court to commence a 'customer protection proceeding' and may itself be appointed as liquidator. In the stockbroking context, it may be more efficient for SEGC as operator of NGF to be appointed (first) liquidator of failed ASX members with immediate access to NGF funds to facilitate unwinding outstanding transactions (particularly if there is a deficiency in Trust account) rather than waiting to compensate for realised losses. Once having fulfilled its statutory obligations, SEGC could then hand on the task of 'final' liquidation.

We trust that the above is of assistance to the Treasury in its difficult task of assessing appropriate compensation arrangements. We would be pleased to participate in any further consultation prior to the final report being settled, and once again thank you for the opportunity to raise and discuss these matters with you and your staff.

If you require any further information, please contact me on 03 9654 3270 or e-mail [dclark@sdia.org.au](mailto:dclark@sdia.org.au).

Yours sincerely,



**Doug Clark**  
**Policy Executive**