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Ms Ruth Smith
Financial System Division
The Treasury
Langton Crescent
PARKES ACT 2600

Dear Ms Smith

COMPENSATION FOR LOSS IN THE FINANCIAL SERVICES SECTOR

SFE welcomes this opportunity to provide its comments on Treasury's Issues and Options Paper on Compensation for Loss in the Financial Services Sector.

The SFE's submission (attached) principally focuses on Chapter 7 of the Options Paper with some additional commentary provided on other issues.

This issue is one which, in our view, would benefit from at least one more iteration at the broad policy framework level before different sectors will be sufficiently incentivised to devise workable arrangements within any broadly accepted legislative framework.

We look forward to contributing to the process as you narrow down the options into a preferred model.

Yours sincerely

Malcolm Starr

Malcolm Starr
General Counsel & Company Secretary

SFE COMMENTS ON COMPENSATION ARRANGEMENTS

General Principles

1. The first priority should be to establish a more appropriate standard for intermediary liability than the existing standard under chapter 7 of the Corporations Act (breach by the intermediary of any of its obligations under that chapter). Any uniform standard that actually results in compensation, no matter how lowly capitalised the licensee, will presumably involve new insurance or levy arrangements for some classes of financial service provider.

It would seem prudent to adopt a relatively narrow standard involving unequivocally serious misconduct (e.g. fraud or defalcation) as the basis upon which to mandate participation in compensation arrangements administered for a particular class of financial service providers. Otherwise, disputation about the capacity of intermediaries in particular sectors to meet broader standards is likely to thwart progress towards establishing the infrastructure for each class of financial service provider.

2. Adoption of a uniform standard of liability should not involve pooling of the risks of breaching this standard attributable to all financial service providers. Instead, an applicant for a licence (or someone who has obtained a licence prior to the new standard being adopted) should be required to demonstrate (if they are not able to secure insurance to cover the risk) that they belong to a scheme which provides satisfactory assurance that either:

- moneys will be payable out of a fund to meet their clients' claims; or
- other participants in an approved risk-sharing arrangement will be levied in order to meet their clients' claims.

3. The existing obligations on market operators to establish and maintain compensation funds should be repealed. There would be a need for transitional provisions bringing an end to the statutory trusts upon which existing licensed market operators hold assets in compensation funds established prior to the FSR amendments to the Corporations Act. These amendments would need to be the subject of detailed discussions with the operators of each fund.

RESPONSE TO SPECIFIC ISSUES RAISED IN CONSULTATION PAPER

Principle Issue 1

Can you provide any evidence of the nature and extent of losses suffered by consumers of financial services to assist us to understand the extent of the problem?

Over the 16 years during which SFE has operated fidelity funds, there have only been claims made against three (former) intermediaries, involving an aggregate of around 30 customers, with the aggregate payout being approximately $640,00. There have been no claims since 1993.

Principle Issue 2

Is requiring compensation arrangements in the Financial Services Sector justified?

See General Principles above. The objective of promoting confidence in being able to deal through intermediaries needs to be reflected in risk pooling arrangements that differentiate between different types of intermediary/financial service provision.

Compensation is not the appropriate response to every breach of a licensee's obligation. Such an approach would impose unjustifiably high barriers to entry.

Principle Issue 4

(a) In what circumstances should compensation arrangements be required in relation to a financial services licensee?

See General Principles above. Fraud or defalcation involving retail clients would be an appropriate starting point. The scope for broadening this standard could be explored in a second phase, after it is clear that this initial standard was achievable for all financial service providers.

(b) Should different criteria or a different mechanism apply depending on whether a financial service provider is solvent or unable to pay/insolvent?

It is likely to prove impractical to have compensation fund proposals cover insolvency. The first insolvency could be expected to exhaust the entire fund for most schemes. The amount needed to be levied in order to cover insolvency could be expected to be a very high barrier to entry that would cause many existing businesses to forfeit their licence..

(c) Should compensation arrangements relate only to the situation where the financial services licensee is unable to pay/insolvent?

Yes.

Principle Issue 5

Who should be entitled to claim?

Particular industry sectors may be able to sustain higher costs than others However, in order to ensure a consistent base obligation that all sectors can meet, the obligation on intermediaries should be to participate in a scheme that at least enables all retail customers to be compensated.

Access to compensation only for retail investors is consistent with the approach taken by the Government in the Financial Services Reform Act. Wholesale investors are generally in a superior position to review and assess risk, more so than retail clients and financially better off when it comes to the pursuit of legal redress.

Principle Issue 6

What compensation requirements should be imposed on financial services licensees?

(a) Should financial services licensees be required to have professional indemnity insurance? Are there other appropriate mechanism which could be alternatives at the option of the licensee?

The types of liability for which most financial service providers could readily obtain coverage would presumably not extend to the most serious types of misconduct such as fraud or defalcation. Accordingly, professional indemnity insurance should not be regarded as sufficient.

Instead, it is more likely to be seen as a useful adjunct to a scheme directed at levying participants in order to compensate clients of another participant in a scheme for a particular class of financial service provider, i.e. if insurance covered claims at the standard set out in s.912B of the Corporations Act (arising from any breach of the licensee's obligations under chapter 7), then any levy arrangements directed at meeting other (uninsurable or less easily insurable) risks such as fraud or defalcation could be significantly lower, so as not to constitute a barrier to entry.

For information, the arrangements we operate within SFE are as follows.

The relevant Operating Rules require Exchange Participants to "*effect and maintain such form of indemnity as the Exchange may from time to time determine to be appropriate to protect the interests of clients.*" The Exchange requires each Participant to have adequate arrangements in place for compensating clients who suffer pecuniary loss because of a failure by the Participant or its representatives to adequately provide futures broking services pursuant to its futures brokers' licence and the Operating Rules of the Exchange. The Exchange considered that compliance by

its Participants with this Operating Rule would be satisfied by appropriate professional indemnity insurance.

The Exchange Board subsequently determined that each Participant dealing for clients must:

(i) have adequate arrangements in place for compensating persons who suffer pecuniary loss because of a failure by the Participant or its representatives to adequately provide futures broking services pursuant to its futures broker's licence and the Business Rules of the Exchange;

(ii) notify the Exchange, in respect of any liability or potential liability of the type referred to in paragraph (i):

- of any circumstance which is likely to give risk to a claim;
- the receipt of a notice from any person of any intention to make a claim;
- to details of any claim;
- any other matter which the Exchange may require in relation to any insurance policy maintained as required by paragraph (i); and

(iii) notify the Exchange in writing each year of the amount of cover provided to the Participant pursuant to paragraph (i).

The adequacy of the arrangement for each Participant would be dependent upon the type and extent of the business conducted by the Participant. As a minimum, the Exchange expected that the Participant would have civil liability cover of at least $500,000 to be taken out with a reputable insurer. As far as the Exchange is aware, market Participants did not have difficulties in obtaining this insurance.

(b) What should the mechanism be required to cover?

See above.

Principle Issue 8

Should market licensees continue to be required to make compensation arrangements (as they have in the past and are in Part 7.5)?

No. See General Principles above.

The existing obligation is an anomaly reflecting a failure of the FSR amendments to take account of the significance of the prior demutualisation of the exchanges that were in existence when the FSR amendments were enacted. A shareholder-owned market operator is a utility. It is not the same thing as the customers who use the utility. It is those customers, to the extent that they engage in misconduct, who should bear the costs of providing for misconduct by fellow users of that utility.

Principle Issue 8(a)

If market licensees are to continue to be required to have compensation arrangements, what changes to the current Part 7.5 should be made?

Not applicable.

The appropriate question is what transitional arrangements need to be made. The current provisions for ministerial authorisation of use of excess funds will need to be retained in a modified form. They will need to acknowledge that *all* funds are surplus to requirements, not merely the amount in excess of the amount determined to be necessary when a licensee transitioned up to the post-FSR obligations.

Principle Issue 8(b)

Is there justification for a consolidated scheme for financial services licensees who are market Participants?

No.

The SFE strongly opposes a consolidated scheme that pools unrelated risks. The SFE believes that such a scheme would lead to cross-subsidisation whereby high risk/poorly managed business firms would end up being subsidised by well-managed firms from other financial sectors. It should also be borne in mind that each business in the financial sector carries a different risk profile. As such, any arrangements to provide compensation should be tailored to meet the risk profile of that particular financial sector.

Of course, the existing funds have different owners whose property could not be compulsorily acquired except on just terms.

Principle Issue 9

Should prescribed CS (Clearing and settlement) facility licensees be required to have compensation arrangements in relation to unauthorised transfers/certificate cancellation? or some wider conduct?

We understand that this question is intended to relate to systems for transferring title to limited classes of "securities" rather than to clearing and settlement facilities generally. It would be useful if the intended scope of this issue could be clarified in any future iterations of the consultation paper.

Principle Issue 10

Do the financial services industry and consumers consider that a broad statutory scheme is warranted?

See General Principles above.

Principle Issue 11

If a broad statutory scheme is warranted, when should it be available?

(a) Should it be available prior to insolvency? or only on inability to pay/insolvency?

(b) On what grounds should claims be paid?

See the SFE's response to Principle Issue 8(b).

Secondary Issue 12 to 14

The SFE's response to the broad statutory scheme mechanism means that we will not be addressing Secondary Issues 12 to 14 inclusive.

Secondary Issue 15

If market licensees were no longer required to make compensation arrangements, what should happen to the funds in the national Guarantee Fund and the exchange fidelity funds?

See the SFE's response to Primary Issue 8(a) and (b) above.

Other Issues

Excess Funds

Secondary Issue 23

Should excess funds in a compensation scheme be available for financial industry development purposes, or should there be mechanisms to discourage the build up of such excess funds?

Much greater scope needs to be provided for operators of funds to avoid the build up of funds without the degree of ministerial involvement and unduly restrictive tests (as to what is excess) that were introduced in the FSR amendments.