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Submission in respect of:

Compensation for Loss in the Financial Services Sector
Issues and Options

I have read the Treasury Report and I congratulate those involved in providing such a foundation for discussion and I am grateful for the opportunity to provide input.

My observations
With respect to the magnitude of the problem I can say that from my own 16 years of experience in financial planning I believe the instances in which consumers have suffered as a result financial service licensees not having adequate assets to meet claims arising from clients' losses resulting from misconduct in the course of providing financial services is very rare. Thus, the magnitude of the problem as outlined in section 34 of the Issues and Options paper seems small. Also, I have never – not once – ever seen any indication or evidence that suggested that consumers of financial services have ever lost confidence in the financial marketplace as a result of financial service licensees not having adequate assets to meet claims arising from clients' losses which result from misconduct in the course of providing financial services (e.g. fraud). Thus, the government objective as described in section 55 seems to have been very satisfactorily achieved by the existing arrangements. Thus, my own view is that there is no evidence that warrants extreme action.

However, satisfactory results to date do not justify complacency - improvement may be possible. Also, section 912B of the Corporations Act requires a degree of change.

Observations about the financial services industry
Before considering any changes to meet the requirements of section 912B it is worth noting that the financial services industry may be divided into two broad categories.

- Institutional dealers (i.e. those that either have such deep pockets themselves or which have a parent company with such deep pockets that there is no doubt as to their financial capacity to compensate consumers in the event of fraud or other misconduct)

- Independent dealers (i.e. those dealers that do not have deep pockets and are not related - in terms of the usual meaning of "related" as used in the ITAA, Corporations Act and common law - to major companies with deep pockets.)

In the case of the institutional dealers there is minimal risk that the dealer will have insufficient assets to compensate a consumer for misconduct. Perhaps where applicable, ASIC may require the parent company to provide a guarantee but, imposition of further restrictions on institutional dealers would not appear to provide any additional benefit to consumers.

On the other hand when consumers rely on independent dealers there will always be an element of risk that in the event of misconduct the dealer may have insufficient funds to compensate the consumer. This is a natural consequence of maintaining a reasonable level of competition and consumer choice in the industry. If asset requirements were made larger it would create a greater barrier to entry and could severely restrict new entrants to the financial services industry and thereby limit the choice available to the consumer. The public support given to the independent dealers to date indicates that they do not consider the risk of a dealer's assets being inadequate to meet claims arising from misconduct to be a significant issue. My own observation is that consumers are far more concerned issues such as market risk, legislative uncertainty and change, and their perception of the advisors skill and integrity than they are with the risk of misconduct or the assets of the dealer. (This is perhaps an issue in itself. Perhaps the Government has already created an environment that is "too safe" in the sense that some people may now feel so safe that they take no precautions to protect themselves. The sharks of this world would be much less successful if consumers were more alert to the risks they face.)

Assessing the risks
Before introducing any measures to reduce this risk one should examine the magnitude of this risk.

While I do not have access to data with respect to claims handled by the Financial Industry Complaints Service (FICS) I suspect that number of cases of fraud or other misconduct by independent dealers would be very small relative to the number of consumers served by independent dealers. I also suspect that if these cases were investigated very few cases would be found where a consumer failed to receive adequate compensation as a result of the dealer having insufficient assets. It should not be difficult to obtain data from FICS with respect to the incidence of fraud by independent dealers, the extent to which the assets of small dealers have proved to be inadequate to meet claims, and the average annual aggregate inadequacy.

If I am correct then there is no need for extreme measures. Rather, all we need is an arrangement, or perhaps a series of arrangements, that will both protect the consumer by both lessening the likelihood of fraud and by compensating the handful of unfortunate consumers who may suffer as a result of misconduct.

Flow-on effects to consumers.
Also, before introducing any measures to reduce this risk one should consider not only the immediate risk reduction to consumers, but also the likely flow-on impact of those measures on the consumers whom they are designed to protect. For example, if

the measures involve extra cost, effort, or risk to the dealer then in a free market it is to be expected that these burdens will ultimately be passed on to the consumer. (Anyone who suggests that competition in the industry will cause the industry to absorb the burden does not understand the reality of business economics.) The flow-ons need not be purely price increases; they could also be in the form of poorer levels of advice, service, competition, and consumer choice.

Existing arrangements to reduce risk to consumers

Finally, before introducing any measures to reduce this risk one should consider the existing arrangements and the extent to which they appear to have worked well. These arrangements include:

- Professional indemnity insurance
- ASIC's licensing requirements (e.g. screening of dealers, security bond, NTA requirement)
- Legislation which provides for fines, jail and banning by ASIC.

Professional indemnity has proved to be satisfactory in protecting the consumer in that for the price of the annual premium the dealer effectively gives consumers access to a pool of capital that vastly exceed the dealer's own net assets. The dealer also is protected via income protection. The major downside to professional indemnity is that there is minimal competition in this area of insurance and insurers are not very discriminating when it comes to setting premiums. The net result has been that good dealers are burdened with rising premiums as a result of claims made against bad dealers and that, one way or another, this burden is being transferred to consumers.

ASIC's involvement the financial services industry has most likely kept some undesirable characters out of the industry. This is good, but the arrangements that have protected consumers from the undesirable characters have also imposed a burden on the entire industry that remains and as usual it is the consumer who must eventually pay for these protective arrangements. While most people will agree that there is a need for arrangements to be in place to protect consumers there is rarely any attempt to quantify the cost to the consumer of providing this protection. Indeed, no one can say with any certainty whether the cost that has flowed-on to the consumer has outweighed the benefit given to the consumer. My own view is that in principle there should be a screening process to ensure that only competent and responsible dealers are licensed and that it is in the public interest that a dealer should be exposed to a degree of risk in the event that there is some form of misconduct by the dealer. If there were no risk there would be no incentive for caution in appointing representatives or vigilance in supervising representatives and other staff. How big should be the dealer's risk exposure? Big enough to provide sufficient incentive to do the right thing. Small enough so as to not create to major a barrier to entry by good people. (It should be noted that there are two distinct types of barriers to entry. There is a barrier that discourages an individual from obtaining a licence and there is a barrier that discourages an existing dealer from issuing an additional proper authority.)

Legislation which provides for fines, jail, and banning is typically focused on the representative and other staff members who may be tempted to commit some form of misconduct within a dealership rather than the dealer itself. These measures are essential both as a means of discouraging dishonest from entering the financial services, but also as a means to help keep “honest” people from becoming dishonest in times of weakness.

Overall these arrangements have worked well because they tend to prevent those who might commit fraud from being issued with licences and because to those who have been granted licences they provide strong incentives to ensure the proper behaviour of those working under their licence. However, the arrangements do not satisfy section 912B.

Proposed changes to meet the requirements of section 912B

Note: The following paragraphs are intended as a concept for evaluation and further discussion rather than as a definitive solution. Obviously, if the concept is acceptable then there would still be many issues that would need to be resolved and some aspects of the proposal may need to be refined.

Replace the existing security bond of $20,000 with a requirement all dealers must either:

- be a member of a compensation trust such as described below, or
- receive exemption from ASIC on the grounds that their NTA is so large that membership of such a trust would be superfluous to the requirements of section 912B.

The compensation trust would be funded 100% by its dealer members and it would guarantee compensation to consumers in the event of fraud or other misconduct. The trust would then be entitled to try to recover the amount involved from the individual(s) who committed the offence, the dealer concerned, and the dealer’s insurance.

The compensation trust would be obliged to maintain net tangible assets of no less than $100,000 and if the total number of proper authority holders within the member dealers of the compensation trust exceeded twenty then the minimum net tangible assets of the fund would be $5,000 per proper authority holder. (i.e. a compensation trust covering the actions of six proper authority holders would need at least $100,000 and a trust covering the actions of one hundred proper authority holders would need net tangible assets of at least $500,000.

Each dealer would contribute to the compensation trust in proportion to the number of proper authorities issued by the dealer.

Note: The rationale for suggesting that required dealer equity be based on the number of proper authorities issued is as follows. Firstly, the equity must be sufficiently large from the dealer’s perspective to provide reasonable incentive for the dealer to do the right thing, but it must not be so large that it reduces competition by being a major barrier to entry of the financial services industry. Thus, the equity should in some way be proportional to the size of the dealer. One measure of size is funds under management. However, I suggest that the risk of misconduct is more closely related to the number of proper authority holders than the funds under management. The number of proper authority holders is also a much more administratively efficient measure of size than funds under management, it is not constantly changing, and it is much easier to audit.

In the event of a compensation payment being made against a dealer the trust would first apply the equity in the trust of the dealer concerned to the compensation claim. Only in those cases where the compensation payment exceeded the dealer’s equity in the fund would the other dealers suffer any loss. Thus a dealer that had issued ten proper authority holders would have equity of at least of $50,000 at risk. A major feature of this proposal is that it would make a dealer think twice before issuing a new proper authority, because each additional proper authority would expose the dealer to a further $5,000 risk.

The compensation trusts would be managed by the members in such manner as may be acceptable to ASIC.

Dealers would be free to hold equity in any such compensation trust that would accept them. Similarly, each compensation trust would be free to accept or reject dealers as members. If a dealer were unable to gain acceptance to any such fund for whatever reason then they would either be forced to leave the industry or to create their own compensation fund and meet the net tangible asset requirements as detailed above.

The above approach provides very significant advantages over an industry based compensation trust that would be open to all dealers. One such advantage is that dis-economies of scale may exist in such trusts and it would be most efficient to let the market place determine the most appropriate size of such trusts. Another advantage of numerous smaller trusts is less eggs in one basket. If there were misconduct in an industry trust it would impact on the whole industry whereas misconduct in one of many trusts will have a much reduced impact on the industry. However, the major advantages stem from stratification of the compensation trusts in terms of the perceived risk associated with their dealers. (By stratification I mean that the perceived risk associated with the members of any given trust is likely to be relatively homogenous rather than representative of the entire industry.) This stratification would be a natural consequence of compensation trusts being able to reject dealers. These advantages include:

- "Good" dealers (i.e. those perceived by their peers to be unlikely to commit any form of misconduct) would not be burdened by the actions of "not so good" dealers. If there were no claims against the compensation trust the dealers may actually profit from their investment in the trust. On the other hand those who were not accepted as being "good" dealers would be forced to share in the risks of other "not so good" dealers and those that could not be accepted by any compensation trust would either have to stand alone or leave the industry. This would tend to reduce the burden on good dealers relative to bad dealers and assuming a competitive market exists and all other things being equal such a shift in burden will transfer as a benefit to consumers.
- The financial incentive to move to a lower risk compensation trust could be substantial. This would encourage dealers to implement appropriate systems, policies, and procedures so as to reduce the risk of misconduct and to not do those things that are likely to increase risk of misconduct.
- This stratification process would give financial service industry participants a vested interest in keeping closer watch over their colleagues. In effect, the principles of a free market would act as a natural regulator of the industry with zero cost.
- Finally, compensation trusts may be able to negotiate professional indemnity insurance for members. This could lead to much reduced premiums for "good" dealers. There are several reasons for this. Partly, it would be the group buying

power, but more importantly, the unlike the current system where all dealers are tarred with the same brush, the "good" dealers could present themselves as deserving a less than average premium. There may also be scope to negotiate even lower premiums subject to the compensation fund taking on some of the risk that would normally be borne by the insurer.

For similar reasons to those outlined above I also suggest that the existing Net Tangible Assets requirement be revised such that it becomes $10,000 per proper authority issued. This would reduce the barrier to entry of new dealers and thereby improve competition and consumer choice, but would make dealers more cautious when issuing proper authorities and more vigilant in their training and supervision.

I recognise that a compensation fund of $100,000 may no have the capacity to meet 100% of compensation claims, however the concept of "affordable safety" is well accepted in other industries (e.g. construction, aviation) and it should be accepted in the financial services industry. It should also be remembered that the Professional Indemnity insurance and the Net Tangible Assets of the dealer are also available for compensation purposes.

I believe these proposals meet the requirements of section 912B in a very efficient and effective manner. In addition, I believe they would help maintain consumer confidence by not only creating the means to pay compensation in the event of misconduct, but by impacting on the participants in the industry so as to actually lessen the likelihood of misconduct.

Other alternatives

There are of course other alternatives. However, such alternatives as I have examined seem like employing security guards to swat flies in winter with sledge hammers. They typically consume very significant resources to overcome a relatively minor problem in a most inefficient manner. The net result of such alternatives from the consumers' perspective is likely to be minimal benefit in exchange for increased costs, poorer service, reduced competition and reduced consumer choice.

I am particularly concerned with alternatives that focus on Professional Standards. While such alternatives give the impression of raising standards they are in fact more about imposing a processes for giving advice and for conducting a business than they are about delivering better advice or greater security to consumers. The reality is that no amount of codes of ethics, codes of practice, quality management, compulsory professional development, or other methods of "raising of professional standards" will stop thieves from stealing nor will they satisfy the requirement of section 912B. The bulk of those people working in the financial services industry have proved that they are not thieves and the imposition of "higher" standards will not make them more honest nor will it provide greater security for consumers. Indeed consumers may become <u>more</u> vulnerable to thieves who may use the professional standards to create the illusion of integrity. Moreover, there is no evidence to suggest that focus on process will lead to improved quality of advice - it may actually lead to standardised mediocrity and procedures (e.g. client sign-offs) designed to protect the dealer in the event of a dispute with a consumer. Finally, as pointed out earlier, the cost of such standards will ultimately be passed on to consumers. One of these costs may be reduced consumer choice. This is because the burden imposed by such measures will fall relatively heavily on small dealers. Some very good people may be driven out of business as there is a limit to amount of compliance work with which a small dealer can cope. Other good people may perceive the barriers to entry and the barriers to the efficient provision of services to consumers as being too high to warrant participation in the industry. In summary, the net result of actions that focus on procedures and professional standards may well be contrary to the Government's desire to protect the interests of consumers.

Declaration of conflict of interest

All too often it seems that those who lobby hardest for change are those with most to gain by the change. There is already an army of parasites feeding off the financial services industry. For example, solicitors, accountants, auditors, marketers, compliance specialists, researchers, computer services, technical information providers, risk profilers, and those who offer high priced, but mediocre training courses. Add the cost of these people to the cost of maintaining an awareness of legislative changes (ITAA, Corporations Act, Social Security Act) and you can see the justification for the fees already charged within the financial services industry. Clearly, these industries have a vested interest in increasing the compliance costs of the financial services industry irrespective of the cost/benefit to the consumer. Institutional dealers also have a vested interest in increasing the compliance burden on the industry because they know that there are economies of scale in compliance and that the burden of increased compliance will tend to fall more heavily on independent dealers than institutional dealers. Any increase in the required level of compliance will therefore tend to give a competitive advantage to institutional dealers and any decrease will tend to give competitive advantage to independent dealers.

The extent of the conflict of interest should not be under-estimated. If it were to be honestly measured and disclosed it would exceed a billion dollars! This conflict of interest has created a massive incentive for lobbying.

In recent years institutions have spent vast amounts of money to purchase fund managers and major dealer groups. These actions coupled with their own expanded distribution networks leaves them in a dominant position in the market in terms of investment product design, manufacture, and distribution. The extent of this domination is illustrated by a recent survey which shows that over 8,000 financial planners are employed by just 10 institutions and their subsidiaries!

[Source: Money Management, October 3, 2002 page 26]

Consumer preference on the other hand is illustrated by another recent survey of 320 members of the Australian Investor's Association which is reported as finding that:

> *"99 percent believed financial planners who were owned by a fund manager or bank were more likely to recommend that institution's products over all other investments".*

and

> *"up to 80% of investors view independence as the most important factor in choosing an advisor".*

[Source: Money Management, September 5, 2002 pages 1 and 3]

This second quote is particularly significant as it uses the word "independence" despite the fact that for the past decade this word has hardly been used by any dealer.

This usage illustrates that consumers prefer "independent advice from independent dealers" and given that the word "independent" has hardly been used by any dealer in the past decade I presume the respondents to the survey are using the word as it was used in the 1980's rather than the narrow definition contained section 923A (Corporations Act 2001).

The president of the Australian Investor's Association was also reported as saying that:

> *"The growing link between financial planners and large financial institutions would make it increasingly difficult for high-net-worth investors to receive the financial advice they were looking for."*
>
> [Source: Money Management, September 5, 2002 page 3]

In assessing the alternatives actions that may satisfy 912B the above conflicts of interest and the consumer preferences should be noted. Most importantly it should be recognised that any action that is purportedly to protect the consumer, but which may provide further competitive advantage to institutional dealers may ultimately lead to a further reduction in the consumers' freedom to choose what they so clearly value. This reduction being not the result of consumer preferences or competitive market forces, but by the attrition of independent dealers by compliance requirements brought about by self-interested lobbyists.

In view of the conflict of interest that clearly exists I think it appropriate that I declare my position as an owner and director of a licensed dealer that has operated since 1995 without ever having had more than two proper authorities issued at a single time and which has no intention of increasing the number of proper authorities issued as I believe the compliance burden associated with issuing another proper authority already outweighs the benefits.

Please feel free to contact me in regard to the above, but note that I will not be available during January 2003.

Yours sincerely,

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