17 December 2021

Senator Paul Scarr
Chair
Senate Standing Committees on Economics
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Parliament House
Canberra ACT 2600

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Dear Senator Scarr,

SMSF ASSOCIATION SUBMISSION – FINANCIAL ACCOUNTABILITY & COMPENSATION SCHEME OF LAST RESORT INQUIRY

The SMSF Association welcomes the opportunity to provide this submission to the Committee in response to the collection of related bills titled *Financial Accountability Regime Bill 2021, Financial Sector Reform (Hayne Royal Commission Response No. 3) Bill 2021, Financial Services Compensation Scheme of Last Resort Levy Bill 2021 and Financial Services Compensation Scheme of Last Resort Levy (Collection) Bill 2021 ("the Bills").*

The Association supports measures that seek to strengthen consumer protection and support the establishment of a financial services compensation scheme of last resort (CSLR). However, such a scheme must be proportionate, equitable and truly a compensation scheme of last resort. We have concerns that the scheme as set out in the Bills tabled will not achieve all of these objectives.

We note that the proposed scheme will apply to five specified 'subsectors' including financial advice. Our submission considers the impacts on the financial advice sector only.

Genuine Scheme of Last Resort

It is essential that the scheme is structured and functions as a genuine scheme of last resort. This applies equally to the compensation paid to consumers and the payment of Australian Financial Complaints Authority ("AFCA") fees. If it does not meet this objective, there is a significant risk of increased financial burden on financial advisers and ultimately, an increased cost of advice to consumers.

The legislation tabled provides a generalised framework for AFCA on what is considered *"taking reasonable steps to recover."* AFCA will need to design and implement its governance framework to meet this objective. There is a need for the expected level of endeavour and action to be clearly stated and defined.

Accountability is essential to the integrity of the scheme's operation. This includes the accountability of industry participants subject to an AFCA determination. Indeed, there is an industry expectation that active and appropriate measures are taken to genuinely seek and obtain payment.

The need for AFCA to seek compensation for fees that remain unpaid in relation to a matter are understood. It is appreciated that a range of circumstances arise that result in unpaid costs. One such circumstance is where the adviser's is insufficient, including where the insurer does not cover the consumer compensation component of a determination but not the AFCA costs payable by the adviser.

Such cases highlight the deficiencies in the regulation and regulatory oversight with regards to professional indemnity insurance. Concerns regarding professional indemnity insurance are not new and were raised in the St. John Report in 2012.[1]

We refer to recommendations 2.1, 2.3 and 2.5.1.

> ***Recommendation 2.1: Licensees to demonstrate adequacy of their insurance***
> *Require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs.*
>
> ***Recommendation 2.3: A more pro-active stance by ASIC***
> *ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate professional indemnity insurance cover and any new requirement in regard to financial resources, and in targeting licensees who are most at risk.*
>
> ***Recommendation 2.5.1: Compensation where licensees cease to trade***
> *In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business.*

Stronger regulation and oversight of professional indemnity insurance is urgently needed. A more active approach is needed with strong, robust standards, to ensure that the integrity of industry and appropriate consumer protections are actively maintained.

Current guidance from ASIC in Regulatory Guide 126 notes that "professional indemnity insurance is a way of reinforcing a licensees' ability to meet any consumer losses caused by negligence or a breach of duty by the licensee or its representatives."[2] Further, the guide requires licensees to self-assess their insurance requirements, and to consider various factors when determining the level and type of cover obtained. The guidance is based upon the requirements set out in the Corporations Regulations. Whilst the guidelines and regulations are somewhat helpful, there is no active oversight, regulation, or enforcement.

Neither the Regulations nor the ASIC guidance prescribe minimum requirements or cover inclusions. Such as the requirement for run off cover. ASIC notes that "if exclusions in a PI insurance policy

[1] The Australian Government the Treasury [Richard St. John], *Compensation arrangements for consumers of financial services*, April 2021
[2] Paragraph RG 126.26: ASIC RG 126 (July 2020)

undermine the policy objective, it is hard to see how the cover can be adequate."[3] However, minimum adequacy requirements are not prescribed and are not actively monitored.

There are concerns regarding the level of regulatory oversight with regards to professional indemnity insurance. ASIC's guidance regarding the ongoing assessment states:

> ***RG 126.55*** *We expect you to review your PI insurance or other compensation arrangements at least annually to ensure that they continue to be adequate (e.g. when your existing policy is due for renewal). You should also review the adequacy of your compensation arrangements in light of any major changes in your business (e.g. if you start providing new services or products or engage more representatives).*
>
> ***RG 126.56*** *From time to time, we may ask you to provide a copy of your PI insurance policy or a certificate of currency and other information relating to your compensation arrangements. For example, we may ask for these documents when conducting a compliance review.*[4]

The level of oversight needs to be more robust with standards actively monitored and upheld. Likewise, the regulations require strengthening.

The Tax Practitioners Board ("TPB") requires all registrants to provide details of the professional indemnity policy held and a declaration that the requirements for insurance have been met. This must be provided on registration and updated at least annually when a policy is renewed or replaced.

Importantly, failure to meet the professional indemnity requirements is a breach of the Code of Professional Conduct and can result in the termination of the individual or entities registration.

The TPB model and standards provides a good working model on which to build upon for the financial advice sector.

Compulsory measures should be in place to provide a minimum level and duration of run-off cover where a financial services business cease. Where the business seeks to reduce the scope of its licensed activities, similar arrangements for run off cover should be in place for the services no longer offered in addition to the professional indemnity cover required for the ongoing business operations.

Similarly, greater work needs to be done with the insurance sector to ensure that policies that meet the required standards are available to the market and are fit for purpose. This has been left unchecked for far too long and has resulted in issues such as limited access to run off cover.

With appropriate standards and regulations that are actively regulated by ASIC, it is likely that many claims that seek to be remedied via this scheme would be adequately addressed via professional indemnity insurance.

The issues surrounding professional indemnity insurance are serious and in need of urgent review. A Government funded review is required as a matter of urgency.

[3] Paragraph RG 126.45: ASIC RG 126 (July 2020)
[4] ASIC Regulator Guide 126: Compensation and Insurance Arrangements for AFS Licensees (July 2020)

Cost to Industry

As discussed above, there are concerns around the future cost to industry, and ultimately individual advisers. Costs levied upon Australian Financial Services Licensees ("AFSL") will be passed on to the individual adviser and then to consumers.

We acknowledge that the Bills tabled have addressed the funding concerns identified in the exposure draft regarding the costs of establishing the scheme and the payment of retrospective claims that have accumulated since 1 November 2018.

However, going forward, the scheme is at risk of becoming reactionary given industry may be called on during the year to pay an additional levy. This creates significant anxiety and a perpetual, unquantifiable, contingent liability for the advice industry.

Overall, the scheme provides a funding source with no recourse to industry. Importantly, the scheme cannot be allowed to devolve into an alternative funding model for AFCA to reclaim unfettered costs. Transparency and accountability of the costs incurred and then claimed via the scheme is paramount.

This is particularly important when we consider the actual or perceived conflict of interests that arise with regards to the CSLR operator, and the close relationship it will have with AFCA.

Strong concerns are held on the choice to replicate the ASIC cost recovery model which has seen the ASIC adviser levy increase significantly over the last three years alone. Here, the divergence between budgeted costs to the actual costs is of deep concern. The result has been a consistent series of increases in the costs passed on to the financial advice sector.

If unchanged, the issues of increasing costs to industry will continue unabated. The impact on costs is expected to be exacerbated by further declines in the number of financial advisers with whom to share that cost. A further decline in financial adviser numbers is expected this month with the 1st of January 2022 an important milestone. This is when the first of the transitional stages of FASEA adviser reforms will reach its end date.

The level of ASIC adviser levy increases experienced over the last three years is unsustainable. These increases would now be added to with the introduction of the scheme.

Whilst the cost modelling for the scheme in the exposure draft was based on existing adviser numbers at that time, this will not be representative of the sector moving forward. It is therefore of concern how the application of the same cost recovery model will impact the advisers who chose to remain in the sector.

Increased advice costs ultimately result in increased costs to consumers, thus providing further barriers to accessibility to affordable advice.

For some advisers, there will be concerns on the financial sustainability of their financial advice businesses, when we consider the overall increase in costs to the sector.

One such segment that will be particularly impacted are those firms operating under a limited AFS licence. This is often referred to as the 'Accountants limited licence'. For many practices, the costs of providing strictly limited advice services are not differentiated from those offering full financial advisory services. The ASIC adviser levy has had a significant impact on this cohort of advisers causing many advisers to choose to exit the financial advice sector all together – and many of those remaining are now carefully considering their future.

Continued increases in regulatory costs and other compliance burdens have rendered the accountants limited licensing model unaffordable and unsustainable.

Many of the advice firms provider broader financial advisory services are small businesses. Some are self-licensed, however many operate under the licence of a larger AFSL and under contract receive a range of services from their licensee.

The increasing compliance obligations, additional layers of costs, increasing cost recovery based levies, amplified by significant reductions in the number of registered financial adviser is making it increasingly difficult for small business.

The reduction in advisor numbers and continuing increases in the costs of providing financial advice is detrimental to consumers who are unable to access quality, affordable financial advice.

Wholesale Investor Definitions

Of concern is the shift by some advisers to provide wholesale advice only. This removes significant layers of compliance obligations, complexity, and cost in the provision of advice services to qualifying clients. However, someone who is classed as a wholesale investor loses a range of important consumer protections, including access to AFCA and ultimately this proposed scheme.

The reasons for the exclusion of wholesale investors is acknowledged. The operative intent was that a party who qualified under these provisions would have greater financial literacy and the means to fund private action in the event of a dispute.

The wholesale investor definitions and operative framework needs urgent review and revision to ensure that updated provisions are fit for purpose and operate as originally intended. Application of the rules can be complex where self managed superannuation funds (SMSFs) are concerned and need greater clarity. For individuals, satisfaction of the asset test can be met very easily by homeowners due to the increases in property prices and the lack of indexation of qualifying thresholds since their introduction.

This highlights the need for an urgent review of financial advice and the complex legislative framework that under pins it. Otherwise, there is great risk that some industry participants will pivot their businesses, quite legitimately under the current law, rendering the consumer protection objective of these Bills impotent.

Exclusion of Product

The SMSF Association is deeply concerned that the scheme does not adequately incorporate all market participants. What is proposed will apply to financial advisers and other specified subsectors only and will not extend to product manufacturers or managers. Of particular concern is the exclusion of those in the managed investment scheme environment.

Often quoted in the House, Senate and Media are "failures" that have significantly impacted consumers. These cases are consistently linked as failures in the financial advice sector. Consistent and persistent references are made to large corporate failures and those of product providers or manufactures in those discussions. Recent examples being Westpoint, Trio, Opes Prime, CommInsure, Timbercorp, and Storm Financial.

There needs to be a clear delineation between product or corporate failures, and the provision of financial advice.

Over the years SMSF members have been impacted by the failures of managed investment schemes (MIS). Trio Capital, a responsible entity for 28 MIS, is one such example. Many SMSF members lost considerable amounts of money due to the fraudulent activities of the scheme operator.

In the Trio case, exposure to fraud resulted in significant losses for direct investors and superannuation funds. The superannuation funds involved included both large APRA funds and SMSFs. In total, 415 direct investors and 285 SMSFs had no access to compensation.

Conversely, 5,358 members of APRA regulated funds received almost $55 million in compensation under Part 23 of the Superannuation *Industry (Supervision) Act 1993* ("SIS Act") . The financial assistance scheme under Part 23 of the SIS Act only applies to APRA regulated superannuation funds. No other mechanism for compensation was available for direct investors and SMSFs despite significant losses being incurred by these investors.

It was determined by the Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into the collapse of Trio Capital* (May 2012), that a scheme of the nature provided for in SIS Act Part 23 was not appropriate for the SMSF sector. The SMSF Association agrees with this finding but considers the Trio case exposed a significant gap in the compensation options available to many investors and highlights the need for an alternative mechanism to protect both direct investors, unadvised investors and SMSFs.

The St. John report (2012)[5] called for a review of professional indemnity insurance and the introduction of a compensation scheme of last resort. The lack of regulatory oversight of professional indemnity insurance, discussed previously, remains a serious issue some nine years later.

Concerns were raised that *"such a scheme would impose upon well managed product providers the obligation to bear losses incurred by badly managed or negligent providers."* [6] Yet in essence, this is the type of model that is proposed for financial advisers.

Where losses are incurred due to misconduct, misrepresentation or fraud of a product issuer or manufacturer, consumers have a right to be protected. The exclusion of this group is of concern given the significant losses that have been suffered by direct investors and SMSFs in the past.

A proactive model that operates on a future funding methodology would alleviate the financial risk and burden to the sector and would ensure that all participants contribute to the fund. This would be preferable to a reactionary model when a significant event occurs which creates a significant financial burden for those that remain.

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[5] The Australian Government the Treasury [Richard St. John], *Compensation arrangements for consumers of financial services*, April 2021

[6] Parliamentary Joint Committee on Corporations and Financial Services: *Inquiry into the collapse of Trio Capital,* May 2012

Where a product fails, currently the only recourse that is available to consumers is to lodge a complaint with AFCA or take legal action against the adviser involved. This was noted in the St John report in 2012 and continues to be the case today. To seek redress, a consumer will need to demonstrate that there was a deficiency in the advice provided in order to seek compensation.

We acknowledge that AFCA, when assessing claims, seeks to carefully assess, and appropriately dissect claims between inappropriate advice and product. However, the scheme by its nature is placing a spotlight on advisers for the allocation of fault. It is only natural that a complainant will seek restitution from any available sources and is encouraged to build the strongest case possible in support of the only avenue for them to claim. Conversely, serious misconduct, misrepresentation or fraud of a product issuer or manufacturer, is given a free pass, given their specific exclusion from the proposed scheme.

Should you have any questions about our submission, please do not hesitate to contact us, and we thank you again for the opportunity to provide this submission.

Yours sincerely,

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SMSF Association

ABOUT THE SMSF ASSOCIATION

The SMSF Association is the peak body representing SMSF sector which is comprised of over 1.1 million SMSF members who have more than $700 billion of funds under management and a diverse range of financial professionals servicing SMSFs. The SMSF Association continues to build integrity through professional and education standards for advisors and education standards for trustees. The SMSF Association consists of professional members, principally accountants, auditors, lawyers, financial planners and other professionals such as tax professionals and actuaries. Additionally, the SMSF Association represents SMSF trustee members and provides them access to independent education materials to assist them in the running of their SMSF.