7 October 2022

Senator Jess Walsh
Chair
Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Senator Walsh,

Financial Services Compensation Scheme of Last Resort Levy Bill 2022 [Provisions] and Financial Services Compensation Scheme of Last Resort Levy (Collection) Bill 2022 [Provisions]

Chartered Accountants Australia and New Zealand, CPA Australia, the Financial Planning Association, the Institute of Public Accountants and the SMSF Association support the implementation of a 'true' compensation scheme of last resort.

We believe it is essential that there is an appropriate external dispute resolution (EDR) framework for the financial services sector that ensures industry participants are accountable for the financial products and advice they provide. The framework should appropriately protect consumers and, where necessary, allow them access to adequate compensation and redress.

It is for these reasons that our associations support the Government's intent to establish a Compensation Scheme of Last Resort (CSLR), which will help fulfil this objective while also supporting confidence in the financial sector's dispute resolution framework.

However, we are concerned that the scheme proposed in the Bill has significant short comings, including its narrow scope, that it appears to provide inadequate coverage to consumers and that it does not look to address the underlying causes of unpaid determinations.

We believe that all financial product providers and advisers, not just those in the retail financial advice sector, have a shared responsibility to lift the confidence and trust in the sector.

Further, the proposed scheme will arguably add significant cost and complexity to the financial services sector, at the same time when efforts are being made to improve access to affordable quality financial advice.

The financial planning sector has undergone significant structural changes since the *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry*. With the exit of many large institutions, including the big four banks, many financial advisers are now sole traders or small businesses who simply cannot afford the continuing rising costs associated with increased complex regulation. The proposed scheme risks making financial advice less affordable and accessible in an environment where increasing complexity in markets and Australia's ageing population mean that the need for financial advice continues to grow.

We therefore recommend that amendments are made to the draft legislation to ensure that the proposed CSLR can only be used as a last resort, is appropriately calculated, and applies to all financial service industry participants.

Our detailed responses are contained in the Attachment.

If you have any queries about this submission, please contact Keddie Waller, Head of Public Practice & SME on 0401 716 083 or keddie.waller@cpaaustralia.com.au.

Yours sincerely,

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1. Scope of the Compensation Scheme of Last Resort

The proposed CSLR will consider claims for unpaid Australian Financial Complaints Authority (AFCA) determinations (that is, where a complaint was made to AFCA from 1 November 2018) and the determination is in relation to a financial product or service within the scheme's scope.

The Bill proposes that the CSLR will encompass five financial products and services:

- personal advice on relevant financial products to retail clients
- credit intermediation
- securities dealing
- credit provision, and
- insurance product distribution.

It is proposed that the CSLR levy framework will align with the ASIC Industry Funding Model (IFM), which currently applies to 48 sub-sectors across the financial services industry[1].

Of note, the Government announced[2] in August that Treasury will review the ASIC IFM to ensure it remains fit for purpose in the longer term given the structural changes taking place in the advice industry. The Government also announced temporary levy relief for financial advisers during this review, to support Australians having access to affordable professional advice. Given the review potentially may result in structural changes to the current ASIC IFM, this raises concerns with respect to aligning the CSLR levy framework to this model.

Additionally, unless the scope of the CSLR as proposed in the package of Bills before Parliament is amended to include all financial products, not all consumers who engage with an ASIC regulated financial product, with or without seeking professional advice, will have access to adequate compensation and redress. For example, the narrow scope of the proposed CSLR means that managed investment schemes (MIS) and other complex financial products will be excluded.

This exclusion will leave many consumers who invest directly into financial products including MIS, without first seeking professional advice, unable to seek appropriate compensation or redress in the event of a future collapse. This will have a significant impact on the wellbeing and financial security of those individuals and will place further pressure on the social security system as victims will be forced to rely on the Aged Pension.

The proposed scope is in part based on historic unpaid determinations data when financial product issuers were not required to be a member of an EDR scheme and complaints about financial products and providers fell outside the jurisdiction of AFCA's predecessor schemes. However, where losses are incurred due to misconduct, misrepresentation or fraud on the part of a product issuer or manufacturer, consumers should have a right to be protected. The proposed exclusion of this group is of concern given the significant losses that have been suffered by direct investors in the past.

Importantly, we also note that in a previous inquiry into the CSLR Bill that the following comments were included in the final report:

Labor would encourage the government to expand the scope of the proposed compensation scheme of last resort (CSLR) to include MIS's [3].

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[1] ASIC SUPERVISORY COST RECOVERY LEVY REGULATIONS 2017 (F2017L00805) - SCHEDULE 1
http://classic.austlii.edu.au/au/legis/cth/num_reg/ascrlr2017201700805566/sch1.html

[2] https://ministers.treasury.gov.au/ministers/josh-frydenberg-2018/media-releases/temporary-and-targeted-relief-asic-levies-financial

[3] The Senate Economics Legislation Committee report into the Financial Accountability Regime Bill 2021 [Provisions], Financial Sector Reform (Hayne Royal Commission Response No.3) Bill 2021 [Provisions], Financial Services Compensation Scheme of Last Resort Levy Bill 2021 [Provisions], and Financial Services Compensation Scheme of Last Resort Levy (Collection) Bill 2021 [Provisions] p.47

We support these comments. The framework for the scheme should appropriately protect consumers and where necessary, allow them access to adequate compensation and redress.

We recommend that the scope of the CSLR be amended to ensure consumers are adequately protected by including all Australian Financial Services (AFS) licensees who are legally required to be a member of AFCA as part of their respective AFS licence conditions.

This amendment would capture:

- AFS licensees who provide financial services to a retail client and who must be a member of AFCA (*Corporations Act 2001* s912A (1)(g) and s912A(2)(c)). This would include the responsible entity of a registered MIS (further discussed below), and
- Australian Credit licensees (*National Consumer Credit Protection Act 2009* s47(1)(i)).

The levy payable to fund the CSLR could then form part of the annual AFCA membership invoice, which would also streamline the administration and associated operation costs of the scheme. Relevant amendments would need to be made to reflect this provision.

There is a further risk that clients who receive either 'general' or 'wholesale' financial product advice and suffer a financial loss may be deemed by AFCA to have in fact received 'personal' advice and therefore be eligible for compensation.

It is then possible that if such a claim remains unpaid, that it could be paid from the licensed personal advice sub-sector, despite the fact that the unpaid claim was not from this sector.

We do not believe that it is appropriate that a sub-sector may have to fund such unpaid claims where no nexus to the advice provided from that sub-sector has been established. It means those who gave rise to the claim are not required to contribute in any manner to the levy.

All financial product providers and advisers, not just those in the retail financial advice sector, have a shared responsibility to lift the confidence and trust in the sector. They also have a responsibility to pay for claims for which they are responsible.

We recommend that the scope of the CSLR be amended to allow the collection of a special levy from the general advice or wholesale advice sub-sectors where an AFS licensee/s from the respective sub-sector is responsible for unpaid AFCA determinations during a qualifying period.

2. CSLR levy framework

The proposed levy framework is a tax to be levied against relevant industry entities to fund the CSLR, drawing on concepts in place for the similar calculations for the ASIC supervisory cost recovery levy framework.

We have significant concerns that the proposed framework is being modelled on a system that is not fit for purpose, noting the current ASIC Industry Funding Model (IFM) is under review to ensure it is actually an equitable and appropriate model for the longer term.

As we are seeing with the ASIC IFM, those who give rise to claims may not be contributing to the levy depending on a range of factors, including the timing of when they held or cease to hold their AFS licence.

This is of significant concern and may threaten the sustainability of the CSLR for the licensed personal advice sub-sector.

We recommend the formula to calculate the CSLR levy is amended to better capture risk of failure to pay compensation by including a general payment across all AFCA members, and a graduated levy based on AFCA complaints which progress past the merits assessment.

This will better capture licensees who are at higher risk of unpaid determinations to fund the bulk of the scheme.

3. Sub-sector levy cap

We note that the sub-sector levy cap in the *Financial Services Compensation Scheme of Last Resort Levy Bill 2022 No , 2022* is proposed to be $20 million. Yet in the *Financial Services Compensation Scheme of Last Resort Levy Bill 2021* the sub-sector limit was $10 million.

This is a significant increase with no consultation nor discussion to explain the increase in the Explanatory Memorandum to the Bill.

In the past financial year, a decline from 534 to 241 (down 54%) was reported for complaints about inappropriate advice. Complaints about the failure to act in the clients' best interest fell from 525 to 281 (down 46%).

Given these figures and given that there are now less than 16,000 financial advisers remaining who are authorised to provide personal financial advice, we question why it is necessary to double the proposed sub-sector cap to $20 million. This is particularly concerning looking ahead when we consider the forecasted financial adviser numbers. Modelling has shown these could fall to 15,000 by 1 January 2023 and could be as low as 12,000 by 1 January 2026.[4]

The decision to increase the sub-sector levy cap appears to ignore the fact that many financial advisers are now sole traders or small businesses, who are faced with rising costs associated with increasingly complex regulation.

We believe the proposed scheme therefore risks making financial advice less affordable and accessible in an environment where increasing complexity in markets and Australia's ageing population mean that the need for advice continues to grow.

We therefore recommend that the sub-sector cap is amended in the Bill to $10 million.

4. The role of Professional Indemnity Insurance

If financial services are being provided to retail clients, there must be arrangements in place to compensate aggrieved clients for breaches of Chapter 7 of the Corporations Act 2001 (Corporations Act). The primary way for AFS licensees to comply with this obligation is to require them to have Professional Indemnity Insurance (PII) cover.

A contributing factor to the need for the CSLR is the failure of PII to respond appropriately to disputes, often leading to awarded decisions by AFCA remaining unpaid. Accessibility and affordability of PII for the retail personal financial advice sector have been challenges for many years, with the impact of the Financial Services Royal Commission resulting in some PII providers exiting the market.

The shrinking nature of available cover and the rise in associated risk premiums have resulted in many AFS licensees increasing their excess payable or accepting exclusions in cover to secure PII on an ongoing basis. It is also not uncommon for the approval process for PII to take three to six months. To ensure adequate consumer protection and the viability of a true CSLR, AFS licensees must be able to access affordable cover that is adequate for the nature of the AFS licensee's business, and which can adequately meet the potential liability for compensation claims.

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[4] Adviser Ratings "One Big Change Could Halt the Mass Adviser Exodus", 9 March 2022, https://www.adviserratings.com.au/news/one-big-change-could-halt-the-mass-adviser-exodus/

We recommend that Treasury undertakes a government funded thematic review of PII for the retail personal advice sector, focusing on keys risks including:

- **accessibility**
- **adequacy**
- **exclusions, and**
- **impact on capital adequacy of the AFS licensee.**

As noted above, to ensure the viability of a true CSLR all AFS licensees must continue to hold appropriate PII cover. However, it is our understanding that ASIC only assesses if PII cover is appropriate for an AFS licensee at time of application or as part of a surveillance activity. In contrast, registered tax agents and BAS agents are required to provide details of their PII policy at time of application and must demonstrate at renewal of their registrations that they continue to hold appropriate PII that meets the requirements of the Tax Practitioners Board. A range of penalties can be applied for non-compliance with this requirement

We recommend that ASIC adopt a similar model for AFS licensees. This model would have many benefits, including:

- ensuring that the AFS licensees continue to hold appropriate PII cover
- sending a signal to all participants that the regulator will be proactively regulating this obligation, motivating some non-complaint, or at risk, AFS licensees to retain appropriate cover, and
- providing insight to the regulator on trends and issues that may be occurring in the PII market.

We recommend that ASIC requires all AFS licensees to submit their PII cover details as part of their existing annual compliance obligations. ASIC should audit a random sample across market participants to ensure there is adequate consumer protection for the users of financial products and advice.

5. Managed Investment Scheme registration and oversight

To register an MIS, the proposed responsible entity must:

- be a registered Australian public company
- hold an AFS licence authorising the responsible entity to:
    - operate the scheme (either an 'in-kind' scheme authorisation or 'named-scheme' authorisation)
    - provide any other relevant financial services in relation to the scheme and its underlying assets.

The responsible entity must also submit an application to ASIC that identifies the kind of scheme that is being registered, along with the scheme's compliance plan that should consider issues such as compliance controls that will respond to the identified compliance obligations, risks and objectives.

Registered MIS are also required to meet financial obligations, as the holder of an AFS licence, which include that:

- the entity must be solvent at all times
- sufficient resources are available to meet anticipated cash flow expenses, and
- information about compliance with these financial obligations must be included in the annual audit report.

Given this, we believe it is reasonable for an individual considering investing directly into an ASIC registered MIS, that holds an ASIC issued AFS licence, to be able to have a level of comfort that the company has had an appropriate level of assessment and oversight from the regulator, such that it is appropriate for the MIS to be commercially operating.

However, in its submission to the Parliamentary Joint Committee Inquiry into the collapse of Trio Capital Limited in 2011, ASIC stated:

Consistent with the economic philosophy underlying the FSR regime, ASIC does not take action on the basis of commercially flawed business models. A significant feature of a number of collapses leading to investor losses is flawed business models—that is, models that could only prosper if asset prices continually rose and debt markets remained open and liquid. Responsibility for flawed business models lies with management and the board.[5]

While this statement is some years old and we recognise ASIC can now apply product intervention powers, we question the appropriateness of the current regulation and oversight of registered MIS products if a commercially flawed business can be 'approved' and offered to the community. Of further concern is that often these products are complex and high risk, yet they are marketed directly to consumers through seminars and targeted advice.

We also question if this approach aligns with the statement of expectations for ASIC that it promotes the sound functioning of capital markets and the corporate sector for the benefit of businesses and households.

Minister Jones' second reading speech acknowledged the recommendations of the former Senate Economics Legislation Committee including *'the recommendation to include managed investment schemes in the scope of the CSLR*'. It was also stated that '*The scope of the CSLR reflects financial products that have a history of unpaid determinations.'*

AFCA data currently shows that MIS currently represents some 43.35% or $6,386,774[6] of unpaid claims for closed complaints for insolvent firms.

Whilst we acknowledge Minister Jones statement that '*The government will continue to consider potential enhancements to the regulatory framework of managed investment schemes*,' we hold concerns that a significant consumer protection gap exists in current regulatory settings in relation to these financial products. This must be addressed to protect those who choose to invest in such products without seeking professional advice – either by choice or because they may not realise that they are directly investing in a financial product.

A notable example is the investors in the Sterling Income Trust who would be excluded and denied compensation under the proposed scheme. These investors were retirees who thought they were participating in a rent for life scheme, not a MIS. These investors lost their life savings, their homes, security, and dignity in retirement. The impacts of this failed scheme were so egregious, a separate Senate Inquiry was held, with the final report being delivered on 4 February 2022.

We recommend a review to assess the adequacy and effectiveness of the regulation and oversight of MIS to ensure that the community is appropriately protected and to assist in preventing future consumer losses.

5 PJC Inquiry Into the collapse of Trio Capital Limited, Submission by the Australian Securities and Investments Commission. p.15

6 AFCA "Overview of Insolvent Financial Firm Complaints and Unpaid Compensation", 1 September 2022 https://www.afca.org.au/news/statistics/overview-of-insolvent-financial-firm-complaints-and-unpaid-compensation