The Association of Superannuation Funds of Australia Limited
ABN 29 002 786 290
ASFA Secretariat
PO Box 1485, Sydney NSW 2001
p: 02 9264 9300 (1800 812 798 outside Sydney)
f: 02 9264 8824
w: www.superannuation.asn.au

asfa
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File Name: 2011/34

19 August 2011

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
Canberra ACT 2600
Australia

Email: corporations.joint@aph.gov.au

INQUIRY INTO THE COLLAPSE OF TRIO CAPITAL AND ANY OTHER RELATED MATTERS

The Association of Superannuation Funds of Australia (ASFA) would like to provide this submission in relation to the Inquiry into the collapse of Trio Capital and any other related matters (Inquiry).

About ASFA

ASFA is a non-profit, non-political national organisation whose mission is to protect, promote and advance the interests of Australia's superannuation funds, their trustees and their members. We focus on the issues that affect the entire superannuation industry. Our membership, which includes corporate, public sector, industry and retail superannuation funds, plus self-managed superannuation funds and small APRA funds through its service provider membership, represent over 90% of the 12 million Australians with superannuation.

The terms of reference of the Inquiry

Of the eleven terms of reference of the Inquiry, the third, fifth, sixth and eighth are directly relevant to superannuation, as follows: -

> *3. the relationship between the SMSF arrangements and regulatory coverage;*
>
> *5. the APRA regulatory relationship to Trio Capital and the use of SMSF;*
>
> *6. the access to compensation and insurance for Trio Capital investors including in circumstances of fraud;*
>
> *8. whether there are adequate protections against fraud for those who invest through self-managed superannuation funds as opposed to other investment vehicles;*

ASFA has sought input from its members with respect to the third, fifth and eighth terms of reference regarding self-managed superannuation funds and hopes to provide a further submission covering these terms of reference.

Access to compensation and insurance for Trio Capital investors including in circumstances of fraud

A) Compensation arrangements generally in the financial services sector

Compensation arrangements are critical to maintaining the integrity of, and confidence in, the financial services industry.

The current compensation arrangements under Chapter 7 of the *Corporations Act 2001* (Corporations Act) are predicated upon the licensed financial services or product provider (financial provider) having in place adequate and sufficient professional indemnity insurance (PII) to assist in meeting a compensation claim. There will be circumstances, however, where PII is inadequate, or unavailable, to respond to a claim for compensation.

B) Professional Indemnity Insurance

In 2006 the Australian Securities and Investments Commission (ASIC) engaged Alan Mason of Melzan Pty Ltd to conduct research into the state of the PII market in Australia in relation to licensees (Report 107).[1] Report 107 stated that: -

"*Adequacy presents a range of issues which require careful consideration including:*
- *Cover is bought/sold to cover all of the entity's liabilities for all of its business activities. It must therefore be adequate to cover wholesale as well as retail exposures and activities beyond the scope of the FSRA;*
- *Cover includes for defence costs in defending the licensee against actions brought by a consumer (or others). These need to be assessed in addition to the required 'limit of indemnity' to meet compensation claims.*
- *Consumers have no direct right of access to PII policies.*
- *Insurers are not a party to External Dispute Resolution (EDR) schemes determinations. A licensee's exposure to an EDR scheme is broader than the protection under a PII policy.*
- *Insurer's monetary exposure to EDR scheme determinations is capped by individual claim and in the aggregate.*
- *Excesses are amounts for which the licensee is not insured. These are a standard feature of all contracts. The licensee needs to have the capacity to meet its exposure to paying claims within its excess.*
- *Although cover is widely available, blanket cover is not.*
- *No insurer offers insurance that covers all possible acts or omissions by all possible persons (from employees, directors, sub-contractors and authorized representatives) for which a Licensee may be liable to any number of retail clients.*
- *The terms and conditions vary considerably between insurers. There is no 'standard' cover for licensees, except where an industry association has developed a scheme (as in the case of the National Insurance Brokers Association (NIBA) scheme). A buyer with significant market power is able to negotiate wider PI cover than one that does not.*
- *At present, there is patchwork coverage of some key areas that may leave retail clients exposed: authorized representatives acting outside the scope of their authority, fraud and dishonesty, and many conflicts of interest claims, and claims in respect of products not on an "approved product list".*

[1] ASIC – Report 107 - Compensation arrangements for financial services licensees - Research into the professional indemnity insurance market - December 2006 - Prepared for ASIC by Melzan Pty Ltd http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Report_107_Compensation_arrangements_for_financial_services_licensees_masonreport-compensation.pdf/$file/Report_107_Compensation_arrangements_for_financial_services_licensees_masonreport-compensation.pdf

- *In addition, there is a many policies provide an inadequate level of cover for specific types of claims. Critically, many policies limit the liability of an insurer for multiple claims arising from one event and may not have sufficiently high liability limits to meet claims for breaches of FSR obligations, in addition to other common law and statutory obligations".*[2]

C) Social impact of investors not being fully compensated

If the financial provider is insolvent, the consumer may be left with a compensation claim which can be satisfied only in part or not at all, leaving the consumer bearing some or all of the loss caused by the breach or misconduct of the financial provider.

This can have disastrous financial, personal and social consequences for the consumer, as evidenced in a recent report commissioned by the ASIC Consumer Advisory Panel (Report 240).[3] The report explores the social impact of investors not being fully compensated when they suffer financial loss because of their licensee's misconduct.

To quote Report 240 with respect to its key research findings: -

> *"The main finding of this study is that failure to fully compensate investors who lost money because of the conduct of their managed investment scheme or financial planner can cause the investor severe emotional and financial distress. The second key finding is that investors were unable to fully utilise the current compensation system. Thirdly, the loss experience can have a corrosive effect on trust in the financial system".*[4]

D) Access to compensation and insurance for Trio Capital investors

The single factor which makes the difference between whether a Trio investor receives compensation for 100 percent of their loss or receives a relatively small amount, or perhaps none, by way of compensation is whether they invested through one of the four superannuation funds or through one or more of the fourteen managed investment schemes.

i) Consumers who invested in the Trio Capital Superannuation Funds

By virtue of Part 23 (Part 23) of the *Superannuation Industry (Supervision) Act 1993* (SIS) members of a superannuation fund can be provided with protection where there has been a loss as a result of fraudulent conduct or theft, provided the loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits.

The Assistant Treasurer announced on 13 April 2011 that the Government would grant assistance for 100 percent of the eligible loss to benefit the members of the four superannuation funds which were formerly under the trusteeship of Trio, which amounted to a grant of approximately $55 million in financial assistance.

A levy to fund financial assistance granted under Part 23 can be imposed under the *Superannuation (Financial Assistance Funding) Levy Act 1993* ("superannuation levy").

The Government made the *Superannuation (Financial Assistance Funding) Levy and Collection Amendment Regulations 2011 (No. 1)* on 2 June 2011 to recoup from APRA regulated superannuation funds the $55 million grant to the victims of the Trio collapse. The regulations imposed a levy on APRA regulated superannuation funds and approved deposit funds but not on self managed superannuation funds or levy-exempt funds.

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[2] *Ibid*, pages 5 - 6
[3] ASIC - Report 240 - Compensation for retail investors: the social impact of monetary loss - May 2011
[4] *Ibid*, Page 8

The regulations set a maximum and minimum levy amount and an applicable rate for the levy. The applicable rate was 0.01347 per cent of fund assets, with the maximum levy amount being $750,000 and the minimum levy $50.

ii) Consumers who invested in the Trio Capital Managed Investment Schemes

By way of contrast to consumers who invested in the Trio Capital superannuation funds, consumers who invested in the managed investment schemes can expect to receive little, or nothing, in the way of compensation. It appears that the liquidator, PPB Advisory, has been unable to recover the vast majority of the assets.

It appears somewhat anomalous that a Trio Capital consumer's entitlement to compensation is dependant upon the vehicle through which they chose to invest.

In developing the SIS legislation it was considered appropriate that, where there has been a loss as a result of fraudulent conduct or theft, where the loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits, members of the fund can be provided with protection.

Fraudulent conduct and theft are, by their very nature, near impossible for a member of a superannuation fund to detect or control. If a financial provider has been guilty of misleading or deceptive conduct with respect to the fund, or they, or a third party, have misappropriated assets, there is little a member can do to prevent this or otherwise protect themselves.

This is equally true of consumers who invest in other financial products, such as managed investments, or even directly in equities. If misleading, deceptive or false statements are made, or assets misappropriated, there is often little the consumer could have done to protect themselves against such behaviour.

As such, ASFA supports the creation of a statutory, "last resort" compensation scheme with respect to consumer losses caused by the breach, fraud or misconduct of an insolvent financial services provider. In other words, in circumstances where a financial provider is insolvent, there is no or insufficient professional indemnity insurance available and a loss has been caused by the fraud or misconduct of the provider, partial compensation could be made available to affected consumers.

ASFA made a submission to this effect to Treasury with respect to the Consultation Paper by Richard St. John – "Review of Compensation Arrangements for Consumers of Financial Services" – released in April this year.[5] An extract from this submission has been attached as an annexure to this document.

We thank you for providing us the opportunity to make this submission. We would be happy to provide you with further information or otherwise participate in the inquiry.

* * * * * *

[5] ASFA submission to Treasury with respect to the Consultation Paper by Richard St. John – "Review of Compensation Arrangements for Consumers of Financial Services" – released in April 2011 - http://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_CP/submissions/ASFA.pdf

If you have any queries or comments regarding the contents of our submission, please contact Fiona Galbraith, Senior Policy Adviser on (03) 9225 4021 or by email fgalbraith@superannuation.asn.au.

Yours sincerely

David Graus
General Manager, Policy & Industry Practice

Annexure

Design of a statutory scheme of last resort for losses due to fraud or misconduct

Given that, within the financial sector, the consumer is the least able to withstand the loss caused by a financial provider's breach or misconduct, it would seem apposite to introduce a statutory scheme of last resort to compensate consumers for such losses, in circumstances where the financial provider is insolvent and therefore unable to pay the compensation.

ASFA submits that such a scheme should be statutory and should be utilised only as a scheme of "last resort", where the financial provider whose breach or misconduct caused the loss, which gave rise to the successful claim for compensation, is insolvent.

Further to this, any consumer who has recourse to the statutory scheme should be required to subrogate any rights which they may have against the financial provider to the scheme.

a) Who should be entitled to compensation?

In order to target any compensation scheme correctly, to ensure that the right people are compensated, to minimise the risk of moral hazard and to manage the funding impact on financial providers, it will be critical to determine the class of consumers who will be entitled to compensation.

Without wanting to pre-empt the outcome of the Treasury review of the definition of "retail client", there would be the benefit of simplicity and consistency if any scheme were to adopt the same, or a suitably modified, definition of "retail client" for the purposes of determining who is entitled to compensation.

Having said that, however, and dependant upon the outcome of the review of the definition of "retail client", there may be equitable or other policy considerations which may indicate that the scheme should adopt a different, possibly narrower, definition of eligibility for the purposes of compensation.

With respect to superannuation, we submit that the following should be considered eligible to receive compensation for loss caused by the breach or misconduct of an insolvent financial provider: -

- members of an APRA regulated superannuation fund;
- trustees of a superannuation fund, including a self managed superannuation fund, approved deposit fund, pooled superannuation trust or public sector superannuation scheme which has net assets of less than $10 million, unless the financial product acquired was over $500,000 in value;
- employers, in circumstances where contributions being remitted to a superannuation fund have been misappropriated by an intermediary financial provider, where the employer's business employs fewer than 20 people or, if the business includes the manufacture of goods, 100 people.

This is consistent with the current definition of "retail client" in section 761G and, from a public policy perspective, represents a reasonable measure of the persons and entities who should be compensated for a loss caused by an insolvent financial provider's breach or misconduct.

b) Proven breach or misconduct by an insolvent financial provider

The management of any scheme will necessitate the determination of: -

- whether the consumer is eligible for compensation (eligible consumer);
- whether there has been a breach of financial services laws or misconduct by a provider;
- the extent to which the provider's breach or misconduct caused the loss;
- the extent to which the eligible consumer contributed to, or failed to mitigate, the loss;
- the quantum of the (net) loss which is potentially compensable; and
- whether the financial provider is insolvent.

The rules of the compensation scheme will need to specify the basis upon which such determinations can be made.

ASFA submits that, in determining whether there has been a breach of a financial services law or misconduct; the extent to which the breach or misconduct caused the loss and the extent to which the consumer contributed to, or failed to mitigate, the loss, the scheme may take into consideration the following matters: -

- any judgment by any court or other judicial or administrative body;
- any decision of the Financial Ombudsman Service;
- any determination made by the Superannuation Complaints Tribunal;
- any decision of an arbitrator;
- any settlement agreement reached through mediation, conciliation or other means;
- any finding of a regulator (ASIC or APRA) as to the conduct of the financial provider;
- any finding by a professional body;
- any determination by an insurer with respect to PI insurance; and
- any finding of a liquidator, trustee in bankruptcy or insolvency practitioner

with respect to, or which is in any way relevant to, the underlying matters, issues, conduct or behaviour which caused the loss.

c) Governance

ASFA submits that the scheme should be independent of government and industry, established under statute, have a board of directors and report to ASIC. Board appointments should be made by the relevant minister.

d) Quantum of Compensation Payable

Having regard to the risk of moral hazard and the affordability of the scheme, ASFA submits that the amount of compensation should be determined in accordance with a sliding scale up to a maximum compensable loss.

By way of example, compensation could be payable at the following rates with respect to the eligible loss incurred: -

- 90% of the first $100,000;
- 80% of the next $100,000;
- 70% of the next $100,000
- 60% of the next $100,000; and
- 50% of the next $100,000, up to a maximum of $500,000

which would result in a maximum of $350,000 compensation being payable with respect to claims of eligible loss of $500,000 and above.

e) Funding

ASFA strongly supports the UK, "segregated", model, where financial providers are grouped into one or more "classes" with respect to the various types of financial products or services which they supply. Compensation for eligible claims against an insolvent member of a particular class is first funded by the other members of that class of financial provider.

This aligns the cost of funding the scheme with the class of financial provider whose breach or misconduct gave rise to the loss and provides an incentive for that class of financial provider to improve their behaviour, conduct, professional standards, education and training.

It is also critical that "moral hazard" be addressed by making it compulsory that all financial providers have adequate professional indemnity insurance.

A scheme which does not segregate financial providers into different classes according to the various services or products they provide, but instead applies a "universal" levy across all financial providers, results in inequitable outcomes whereby inherently risky, or less regulated, financial services and products are cross-subsidised by other less risky ones.

This would especially be the case with respect to prudentially regulated superannuation funds, which have to meet standards with respect to capital; managing the risks of the fund; the adequacy of resources, the fitness and propriety of the trustee directors and the outsourcing of material business activities.

Superannuation funds already pay a supervisory levy to be prudentially regulated and supervised by APRA. As a consequence of prudential supervision, superannuation has enjoyed a relatively low incidence of breaches or misconduct causing loss and insolvency.

It should also be borne in mind that superannuation is mandatory, with Superannuation Guarantee ("SG") contributions effectively representing the deferred salary and wages of members.

As many superannuation funds are operated on an "all-profits-to-members" ("not-for-profit") basis, the cost of meeting such levies often ends up having to be deducted from the superannuation fund itself. This results in the members of the fund bearing the loss, not the trustee as the financial provider.

Given that superannuation funds: -

- are prudentially supervised and regulated;
- already pay a significant levy for that supervision, as well as other levies;
- have had a relatively low incidence of failure;
- contain mandated "superannuation guarantee" contributions, which effectively represent deferred salary and wages; and
- generally have to pass the cost of the levy through to members

we submit that it would be inappropriate for the risks with respect to other, largely discretionary, non-superannuation financial services and products to be mitigated by a levy imposed upon superannuation funds.

Accordingly, ASFA strongly submits that, in the event of a loss caused by the breach or misconduct of an insolvent financial provider who supplied a particular type of service or product, any compensation levy must first be applied against only those financial providers which supply that type of service or product (the "segregated" model).

Should a "universal" scheme be contemplated, where a levy is imposed against all financial providers, then for the reasons given above we submit that superannuation funds should be exempt from any such levy.

In the context of superannuation, that would see APRA regulated superannuation funds in a class which would only be liable for a levy with respect to an eligible loss caused by an insolvent trustee of a superannuation fund, similar to the regime which applies now under Part 23 of the *Superannuation Industry (Supervision) Act 1993* ("SIS").

If a trustee of a superannuation fund were licensed to provide personal advice then, to the extent that financial advice formed part of their business, the trustee would also be in the relevant "financial advisers" class.

The Financial Services Compensation Scheme ("FSCS") in the UK is designed whereby, should a particular class exceed its annual maximum levy threshold, the other classes are required to contribute "top-up" funding, up to the maximum levy limit of their own class.

Should a model similar to that of the FSCS be considered, ASFA is of the strong view, for the reasons outlined above, that the "superannuation fund" class should be exempted from contributing to any "top-up" funding. Given that superannuation funds represent the deferred salary and wages of employees, it is inappropriate that they be used to cross-subsidise compensation claims for losses caused by the breaches and misconduct of other types of discretionary financial providers.

One possibility which has been discussed is that of imposing a "pay-as-you-go", pre-funded management levy to fund the operations of the scheme. Given that, in any particular year, there is little likelihood of a claim being payable with respect to a superannuation fund, we submit that the "superannuation funds" class should be exempted from such a levy.

Superannuation funds should only be required to pay a levy if an APRA-regulated superannuation fund fails and compensation is determined to be payable to the members of that fund, similar to Part 23 of SIS.

Given that all of the members of a self-managed superannuation fund ("SMSF") are all trustees of the fund then the trustee(s) of an SMSF will never be liable to pay compensation to the members. Accordingly, trustees of SMSFs should not be liable to pay a levy.

As the consumer of a financial product or service, however, the trustee of an SMSF should be entitled to claim compensation where it has incurred a loss caused by the fraud or misconduct of a financial provider and the SMSF has net assets of less than $10 million (or such other eligibility criteria as may be devised).

Any levy should be determined as a percentage of one or more financial criteria with respect to the financial service or product supplied by the class of financial provider. In the context of the "superannuation funds" class, that would generally be the funds under management ("FUM") of the superannuation fund as at the end of the previous financial year.

It is important, in the calculation of any levy, that the affected financial providers be consulted as to its formulation. The size and composition of financial providers will necessarily change over time and the impact of any levy will be affected by such changes. In each instance the impact on members must be considered.

As such, no single formula can be devised in advance which will guarantee equitable outcomes. Any levy must be determined on a case-by-case basis.

A levy must only be imposed after there is clear evidence of a loss and it is apparent that no other compensation arrangements will be available with respect to the affected consumers.

The compensation scheme must be clear as to the process and the speed with which compensation payments will be paid to consumers. There must also be time to pay in an orderly manner to minimise disruption to returns and cash flows.

Most importantly, in the event of compensation being payable, there must be a full review as to the existence, and extent, of any regulatory gap or issues with the relevant regulator's supervision of the financial product or service concerned which may have resulted in the loss being sustained.

It is becoming an increasing concern across the superannuation industry that it is being seen as a "honey-pot". It should always be borne in mind that any compensation levy comes off members' accounts and this impacts retirement outcomes.

There appears to be a growing perception that levies should be applied first and questions asked later. ASFA strongly argued against the levy now being imposed by AUSTRAC. This is an unfair treatment of members of superannuation funds.

f) Relationship to Part 23 of SIS

In that it covers fraud or theft perpetuated by a third party other than a financial provider, Part 23 has a broader application than any proposed compensation scheme with respect to financial providers. As such, it would be worthwhile retaining, and possibly amending (narrowing), Part 23 to cover fraud and theft by parties other than financial providers, that would otherwise fall outside of the financial providers' compensation scheme.

Regulations to impose a superannuation levy have only been made three times since 1993, in 2003, 2005 and 2011. As the Part 23 superannuation levy is raised relatively rarely (three times in 17 years), there would be negligible incremental or overhead costs involved in retaining a modified (reduced) Part 23 to cover fraud or theft by a party other than a financial provider alongside any universal financial providers' compensation scheme.