



**Australian Government**

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**The Treasury**

Parliamentary Joint Committee on Corporations  
and Financial Services

**Inquiry into the collapse of Trio Capital and any  
other related matters**

19 August 2011

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## INTRODUCTION

1. Treasury's submission to this Inquiry addresses points three, six, eight and nine of the Inquiry's Terms of Reference. In particular, the submission deals with the financial assistance arrangements under Part 23 of the *Superannuation Industry (Supervision) Act* (SIS Act) and the types of superannuation funds covered by Part 23, including why self managed superannuation funds (SMSFs) are excluded from the Part 23 provisions and background information on the regulatory framework for SMSFs.
2. Further, the submission provides an overview of the initiatives the Government has recently announced in relation to its *Future of Financial Advice* (FOFA) reforms.<sup>1</sup> As part of the FOFA reform package, the Government also announced a review of the need for, and costs and benefits of, a statutory compensation scheme for financial services conducted by Mr Richard St John.

## COMPENSATION ARRANGEMENTS UNDER PART 23

3. On 13 April 2011, the Assistant Treasurer and Minister for Financial Services and Superannuation announced a grant of financial assistance of approximately \$55 million under Part 23 of the SIS Act, to benefit members of four superannuation funds regulated by the Australian Prudential Regulation Authority (APRA) and which were formerly under the trusteeship of Trio Capital Limited.

### The legislative regime

4. Under Part 23 of the SIS Act, the trustee of an APRA-regulated superannuation fund or approved deposit fund may apply for financial assistance if the fund has suffered an eligible loss, and the loss has caused substantial diminution of the fund's assets leading to difficulties in the payment of benefits. An eligible loss is defined under section 228 as a loss that is suffered as a result of fraudulent conduct or theft.
5. Where the relevant Minister is satisfied that the fund has suffered an eligible loss, the Minister can determine under subsection 231(1) whether the public interest requires that a grant of assistance be made to the fund.
6. Under the *Superannuation (Financial Assistance Funding) Levy Act 1993*, grants of financial assistance under Part 23 of the SIS Act can be recovered by way of a levy on APRA-regulated superannuation funds and approved deposit funds.

## SELF MANAGED SUPERANNUATION FUNDS

7. Part 23 of the SIS Act specifically excludes SMSFs from applying (subparagraph 229(1)(aa)(i)), unless, under subsection 231(3), the SMSF was an APRA-regulated superannuation fund or approved deposit fund at the time of the eligible loss (and subsequently became an SMSF in the intervening period).

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<sup>1</sup> Further information is available at [futureofadvice.treasury.gov.au](http://futureofadvice.treasury.gov.au).

8. The financial assistance scheme under Part 23 of the SIS Act does not apply to SMSF trustees, on the basis that they have direct control over their superannuation savings. Consequently, SMSFs are not required to pay any financial assistance levy imposed on APRA-regulated superannuation funds when compensation is paid under the scheme.
9. Excluded funds, the precursors of SMSFs, were specifically excluded from the financial assistance scheme when it was first introduced with the SIS legislation in 1993.
10. The scheme has been reviewed several times over the past two decades. The reviews consistently confirmed the exclusion of SMSFs from the scheme.
11. The reviews included the *Financial System Inquiry* (Wallis Inquiry) in 1997,<sup>2</sup> the *Review into the operation of Part 23 of the SIS Act* in 2003<sup>3</sup> and the *Super System Review* in 2010.<sup>4</sup>

### Background on SMSFs

12. SMSFs have the following characteristics:
  - less than five members;
  - each member of the fund is a trustee or director of the corporate trustee;
  - no member of the SMSF may be an employee of another member of the fund, unless they are related; and
  - no trustee or director of the corporate trustee receives any remuneration for their services as a trustee.
13. Almost one million Australians have opted to control their own superannuation via an SMSF. As at March 2011, there were around 447,000 SMSFs, with over 850,000 members.<sup>5</sup> The SMSF sector is the largest single sector of the superannuation industry, holding about 32 per cent (\$423 billion) of total superannuation assets.<sup>6</sup>

### Regulation of SMSFs

14. SMSFs are regulated by the Australian Taxation Office (ATO). The ATO takes a compliance-based approach to the SMSF sector, on the basis that all SMSF members (being trustees or directors of the corporate trustee) are in a position to protect their own interests. In comparison, other regulated superannuation funds are prudentially regulated by APRA.
15. The ATO's role is to ensure that SMSFs comply with all relevant provisions in the superannuation laws, including trustee covenants, investment rules and

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<sup>2</sup> Further information is available at [fsi.treasury.gov.au](http://fsi.treasury.gov.au).

<sup>3</sup> Further information is available at [www.treasury.gov.au](http://www.treasury.gov.au).

<sup>4</sup> Further information is available at [supersystemreview.gov.au](http://supersystemreview.gov.au).

<sup>5</sup> ATO, *Self-managed super fund statistical report – March 2011*. Available at [www.ato.gov.au](http://www.ato.gov.au).

<sup>6</sup> APRA, *Quarterly Superannuation Performance, March 2011 (issued 9 June 2011)*. Available at [www.apra.gov.au](http://www.apra.gov.au).

administrative obligations. The ATO also provides education, assistance and support to trustees and their advisors through a range of information products, standardised forms and other tools.

16. SMSFs pay an annual supervisory levy to the ATO to cover the ATO's costs of their regulatory supervision. The current levy is \$180 per annum (from the 2010-11 income year). The levy is payable at the same time as the fund's income tax liability.

## SMSFs and protection against fraud

17. Note that current compensation arrangements for SMSF trustees who have suffered losses are discussed at paragraphs 35 onwards.
18. The *Super System Review* recognised that, while SMSF trustees bear the sole responsibility for their retirement savings, the vast majority of trustees engage professional service providers. The Government has accepted the Review's recommendations, as announced in *Stronger Super*,<sup>7</sup> to set mandatory minimum qualifications and competency standards for SMSF service providers such as financial advisors and approved auditors. These minimum standards would be aimed at greater consistency among service providers, provide members with greater protection and reduce the risk of inappropriate advice.<sup>8</sup>
19. The Government has largely concluded its consultations with stakeholders on the *Stronger Super* reforms and is now considering the views expressed during consultation in settling the implementation details of the reforms.
20. Establishing an SMSF is only one of a number of options available to retirees to provide an income in retirement. The legislation relating to self managed funds requires that all members are trustees of the fund so that all members are in a position to protect their own interests. Accordingly they are subject to a less onerous prudential regime under the SIS Act and not subject to the financial assistance provisions.
21. Members of SMSFs who seek the compensation offered by the financial assistance scheme may join an APRA-regulated superannuation fund, or appoint a registrable superannuation entity licensee as trustee and restructure as a small APRA fund.

## FINANCIAL ADVICE

### The provision of financial advice

22. The Government has announced reforms in relation to the provision of financial advice, focused on enhancing the quality of financial advice.
23. Concerns about the quality of financial advice and in particular the potential for conflicts of interest to result in consumer detriment were considered by the 2009

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<sup>7</sup> Further information is available at [strongersuper.treasury.gov.au](http://strongersuper.treasury.gov.au).

<sup>8</sup> *Super System Review, Final Report, Part Two: Recommendation Packages*, 30 June 2010, at p 230. Available at [strongersuper.gov.au](http://strongersuper.gov.au).

*Inquiry into Financial Products and Services in Australia (the Ripoll Report)*<sup>9</sup> by the Parliamentary Joint Committee on Corporations and Financial Services, which was set up in the wake of collapses such as Storm and Opes Prime.

## Future of Financial Advice reforms

24. In response to the recommendations of the Ripoll Report, the Government announced the FOFA reform package, which is focused on improving the quality of advice, strengthening investor protection and underpinning trust and confidence in the financial planning industry.
25. The objectives of the FOFA reforms are twofold:
  - ensuring that financial advice is in the client’s best interests – distortions to remuneration, which misalign the best interests of the client and the adviser, should be minimised; and
  - making financial advice accessible to those who would benefit from it.
26. Among the key reforms is a prospective ban on conflicted remuneration structures, including commissions, volume-based payments and soft-dollar benefits of \$300 or more, in relation to the distribution of and advice on retail investment products.<sup>10</sup> The prospective ban also extends to up-front and trailing commissions. The reforms will also ensure that percentage-based fees (known as assets under management fees) can only be charged on ungeared products or investment amounts.
27. The reforms will reduce conflicted remuneration structures in relation to advice on, and distribution of, retail financial products and risk insurance within superannuation. The measure is targeted at removing the current potential for product providers to influence adviser recommendations, as well as targeting other payments which have similar conflicts to product provider set remuneration and that otherwise do not engender the right behaviour. The measure in relation to percentage-based fees is targeted at conflicts of interest where an adviser is incentivised to recommend leverage to increase funds under management and hence fees.
28. The reforms include other measures to improve the quality of advice, enhance consumer protection and enshrine the focus of the adviser on the best interests of the client.
29. There will be a statutory best interests duty for financial advisers, requiring them to act in the best interests of their clients, subject to a ‘reasonable steps’ qualification (when giving personal advice to retail clients). In order to ensure clients understand ongoing fees and to give them an opportunity to consider whether they are receiving value for money, advisers will also be required to get retail clients to opt-in (or renew) their advice agreement every two years.
30. In addition to these changes to enhance consumer protection and improve the quality of financial advice, the Government has committed to ensuring that Australians have

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<sup>9</sup> Further information is available at [www.aph.gov.au](http://www.aph.gov.au).

<sup>10</sup> There are carve-outs from the ban on soft-dollar benefits for professional development and administrative IT services if set criteria are met.

greater access to affordable advice. To this end, the reforms include an expansion in the provision of limited or scaled advice, which will be of particular benefit to individuals and families who may only want piece-by-piece advice rather than a complete financial plan.

31. The majority of the reforms, including the prospective ban on conflicted remuneration, adviser charging, and the statutory fiduciary duty will apply from 1 July 2012.

### Current compensation arrangements for consumers of financial advice and products

32. As part of the FOFA reform package, the Government announced a review of the need for, and costs and benefits of, a statutory compensation scheme for financial services conducted by Mr Richard St John.
33. As a key first step in this review, a Consultation Paper was released in April 2011 and 28 submissions have been received.<sup>11</sup> Mr St. John is in the process of reviewing submissions, undertaking further consultations and preparing his recommendations to the Government.
34. The Consultation Paper describes in some detail the current compensation arrangements, their practical operation and some problems with the current arrangements.
35. In summary, the key elements of the current compensation arrangements are:
  - The *Corporations Act 2001* (Corporations Act) requires licensed providers of financial services (licensees) who deal with **retail** clients to have in place a dispute resolution system (section 912A)<sup>12</sup> and arrangements for compensating clients for loss or damage suffered because of a breach by the licensee of its statutory obligations (section 912B).
  - The default arrangement for compensation provided for in regulation 7.6.02AA of the *Corporations Regulations 2001* is the use of professional indemnity insurance (PII). The PII cover must be adequate having regard to the licensee's financial services business (the volume of business, the number and kind of clients, the kind of business and the number of representatives), and the maximum liability to compensation claims that realistically might arise.
    - The Australian Securities and Investments Commission's (ASIC) Regulatory Guide 126<sup>13</sup> provides guidance to licensees in self assessing the adequacy of the PII cover they acquire. Amongst other things, in ASIC's view, to be adequate a licensee's PII policy needs to 'cover fraud or dishonesty or infidelity by directors, employees and other representatives of the licensee (though such cover is not required for a sole trader)'.<sup>14</sup> It also requires that

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11 Excluding submissions provided 'in confidence', 23 submissions are available at [www.futureofadvice.gov.au](http://www.futureofadvice.gov.au).

12 The dispute resolution system requires the licensee to have an internal dispute resolution mechanism and to be a member of an ASIC-approved external dispute resolution scheme.

13 ASIC, *Regulatory Guide 126, Compensation and insurance arrangements for AFS licensees*, December 2010. Available at [www.asic.gov.au](http://www.asic.gov.au).

14 See RG 126.54.

fraud or dishonesty by directors, employees or other representatives not be excluded from the PII policy.

- The regulations provide an exemption from the need for compensation for a licensee who is a general insurance company, life insurance company or authorised deposit taking institution regulated by APRA, or is a related entity which holds a guarantee from the exempt licensee that is approved by ASIC. Such financial service providers that meet APRA’s prudential requirements, including capital adequacy, are in a stronger financial position to meet operating requirements including the financing of compensation claims.
- ASIC is empowered to approve in writing alternative compensation arrangements but in doing so is required to have regard to the adequacy of those arrangements.

36. As noted above, the compensation arrangements apply where a financial services licensee provides a financial service to persons as **retail clients**, and those persons suffer loss or damage because of breaches of the relevant obligations under Chapter 7 of the Corporations Act by the licensee or its representatives. This focuses a higher level of regulatory protection on those consumers that are relatively less sophisticated or financially literate than ‘wholesale’ clients.

37. The definition of a retail client (sections 761G and 761GA of the Corporations Act) applies in different ways to different financial products:

- A person or small business (for use in connection with that business) that purchases certain general insurance products (such as motor vehicle or home and contents insurance) is treated as a retail client. Further a person who purchases a superannuation or retirement savings account, or financial service related to one of these, is also treated as a retail client.
- The purchase of all other financial products or services are taken to be by a retail client unless they meet one of the following five tests:
  - **Product value:** price of financial product or value of financial product or service is \$500,000 or more – in which case the client is classified as wholesale;
  - **Individual wealth test** (not for businesses) – has net assets of at least \$2.5 million or gross income for each of the last two financial years of at least \$250,000 per annum, certified by an accountant – in which case the client is classified as wholesale;
  - **Business test** – the financial product or service is to be used in connection with a business – in which case the client is classified as wholesale. This does not apply, however, to a small business – in which case the client is classified as retail;
  - **Professional investor test** – includes, for example, financial service licensees, bodies regulated by APRA (but not trustees of superannuation funds holding less than \$10 million in assets) and persons controlling more than \$10 million in investments; and



- **Sophisticated investor test** – requires a financial services licensee to be satisfied on reasonable grounds that the client has previous experience in using financial services and investing in products such that the client can assess the merits, value and risks of the product as well as the adequacy of information given – if this is the case, the client is classified as wholesale.
38. The retail client test is relevant in determining whether a trustee of a superannuation fund, including an SMSF, can access the dispute resolution and compensation arrangements required of financial services providers for retail clients under the Corporations Act. In ASIC’s view, under the law, financial services provided to a trustee of a superannuation fund are generally provided to them as a retail client if the net assets of that fund are less than \$10 million at the time the service is provided.<sup>15</sup>
39. The appropriateness of the current arrangements for distinguishing between wholesale and retail clients, including the tests for trustees of superannuation funds, is being examined as part of the FOFA reforms. The Treasury is presently considering submissions to its Options Paper on this issue.<sup>16</sup> Many submissions expressed the view that the law needs to be clearer in the treatment of superannuation trustees as retail or wholesale clients.
40. Following are some example of the practical application of the current compensation arrangements to the investment choices available to an SMSF (one that qualifies as a retail client under the tests referred to above).
- Where the trustee of an SMSF receives professional financial advice and suffers a loss as a result of investing in accordance with the advice received, an award of compensation is dependent upon establishing that the financial adviser has breached one of their statutory obligations.
    - Broadly, in providing personal advice to a client, an adviser’s key conduct obligations are to make reasonable inquiries into that client’s personal circumstances and having a reasonable basis for the advice provided.
    - For example, an award of compensation might be made if the financial adviser has provided personal advice to the trustees of the SMSF without having had a reasonable basis for the advice given.
  - Where a trustee of an SMSF suffers a loss upon making a direct investment in a financial product, such as in a managed investment scheme, an award of compensation is dependent upon the product issuer or seller breaching a legal obligation.
    - Key obligations on product issuers relate to the disclosure of information on financial products they issue or sell. They are also prohibited from engaging in certain types of conduct, such as misleading or deceptive conduct or the making of false statements. Responsible entities of managed investment schemes are also subject to more specific obligations, including to act

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<sup>15</sup> ASIC, QFS 150. Available at [www.asic.gov.au](http://www.asic.gov.au).

<sup>16</sup> The Treasury, *Wholesale and Retail Clients – Future of Financial Advice, Options Paper*, January 2011. Available at [futureofadvice.treasury.gov.au](http://futureofadvice.treasury.gov.au).

honestly, exercise care and diligence, and act in the best interests of the members.<sup>17</sup>

- As a matter of practice, a retail client might establish a basis for compensation if the product issuer breached an obligation in respect to their conduct towards that client *on an individual basis*. An example would be if, in selling the product, a false statement has been made that materially misrepresents that product in correspondence addressed to that client personally.

41. A retail client does not necessarily have a legal right to compensation where they suffer loss or damage from a fraud perpetrated against the assets of the financial product in which they have invested (for example the investment pool held by a managed investment scheme).<sup>18</sup> Rather, the client needs to establish that they personally have a cause of action recognised by the law (for example under statute or common law) against the licensee or a representative (or both). It is not enough merely to show that they have suffered a loss that relates to misconduct by an employee of the fund manager.

- For example, the case for compensation might be established in the following circumstances:
  - in selling an interest in a managed investment scheme to the client, a licensee’s authorised representative made false or misleading statements about the financial product that are material;
  - the client could reasonably be expected to rely on those ‘false or misleading’ statements, and does in fact rely on those statements in making the investment;
  - subsequent to the investment being made, an authorised representative or director of the responsible entity of the managed investment scheme perpetrates a fraud against the scheme’s assets; and
  - the client suffers a loss in the value of the investment.<sup>19</sup>

42. Further, a retail client that suffers a loss in dealing with an unlicensed financial services provider would have no access to the dispute resolution system and arrangements for compensating clients established in Chapter 7 of the Corporations Act, but could pursue other legal avenues of redress.

43. Whilst a trustee of an SMSF or other retail client may receive an award of compensation for a loss, the receipt of a payment of compensation will depend on the licensee’s capacity to meet their compensation liability. The Consultation Paper observes that PII arrangements ‘provide a measure of assurance but no guarantee

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<sup>17</sup> Chapter 5C of the Corporations Act.

<sup>18</sup> The Commonwealth Director of Public Prosecutions normally prosecutes corporate fraud offences, such as those perpetrated by directors, officers and auditors, under State or Territory criminal law rather than the Corporations Act.

<sup>19</sup> Section 917E of the Corporations Act holds a licensee responsible for a loss or damage suffered by the client as a result of the representative’s conduct (includes an employee or director) whether or not they are acting under authority if the conduct relates to the provision of a financial service; the client could reasonably be expected to rely on that service; and the client in fact relied in good faith (section 917A).

that retail clients will be able to recover compensation to which they may be entitled'. Chapter 3 of the Consultation Paper notes some of the limitations of PII as:

- a timing mismatch, with a claim made in a period when a PII policy is no longer in place (and run-off cover is not available or could not be acquired);
  - A key example of this is where a licensee becomes insolvent or ceases to trade, and the policy expires or is terminated before a consumer makes a claim for compensation;
- a PII policy is in place but does not respond to the claim. For example:
  - the circumstances of the claim are excluded under the policy;
  - the licensee is in breach of a contractual obligation under the policy; or
  - the policy's cap has been reached (for example because multiple claims have been made against the policy).

44. In particular, where an award of compensation is made the extent of payment of that liability for compensation to each consumer will depend on whether:

- that consumer's claim was made during a period when the licensee's PII policy was active and the licensee is not materially in breach of a contractual obligation under the policy; and
- the PII is not exhausted (for example the cap in the policy has not been reached); and
- the licensee is able to meet any excess payment required under the policy.

45. Where fraud has been perpetrated, it is also relevant whether the PII in fact covers, and does not exclude, the circumstances of the fraud. For example, a financial adviser that operates as a sole practitioner would be unable, and is not required, to acquire PII for fraud.

46. Where the PII policy does not meet liabilities for compensation, the licensee remains liable to the clients for the payment of those awards. Where the licensee has insufficient financial resources, the licensee is likely to become insolvent and the claimant will have rights as an unsecured creditor in the winding up of the licensee's business.