

SUBMISSION

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

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
P O BOX 6100
Parliamentary House
Canberra Act 2600

corporations.joint@aph.gov.au

SMSF Professionals' Association of Australia Limited
Level 1, 366 King William St
ADELAIDE SA 5000



SELF-MANAGED SUPER FUND
PROFESSIONALS' ASSOCIATION
OF AUSTRALIA



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Self-Managed Super Fund Professionals'
Association of Australia Limited
(‘SPAA’)

Overview

1. This submission provides SPAA’s response to the inquiry into the underlying issues associated with the collapse of Trio Capital. This submission does not provide specific comment on the circumstances which led to the collapse of Trio Capital but rather this submission provides comments on the adequacy of compensation arrangements for investors, specifically Self Managed Superannuation Funds (SMSFs) investors, who fall victim to the fraudulent activities of financial advisers and scheme providers.
2. The issue of financial loss due to misconduct or insolvency is not limited to superannuation but is a broader issue affecting all investors. Of particular concern are the circumstances in which consumers of financial services suffer losses which they are unable to recover, even when they have a court award or an Ombudsman determination in their favour.
3. In SPAA’s view there is inadequate protection against misconduct and insolvency of an Australian Financial Services (AFS) licensee for those who invest through SMSFs as opposed to other investment vehicles. SMSF members are mostly retail investors who are less able to absorb investment losses when compared with larger funds of the kind regulated by APRA. SMSF members are similar and aligned to ordinary investors in the marketplace and are not similar to APRA regulated fund members.
4. SPAA acknowledges that SMSF investors make a consensual decision to make their own investment decisions but in SPAA’s view that should not result in SMSF members being left to fend for themselves if they lose money due to the misconduct or insolvency of an AFS licensee.
5. To overcome these concerns and to improve consumer trust and confidence in the financial services industry, SPAA supports the introduction of a last resort Financial Services Compensation Scheme to compensate consumers who have suffered loss due to the misconduct or insolvency of an AFS licensee.
6. SPAA acknowledges the extensive work undertaken by the Financial Ombudsman Service (FOS) in this area and their proposal to establish an industry based Financial Services Compensation Scheme (FSCS). SPAA broadly supports the FOS proposal as outlined in their submission in response to the consultation paper by Richard St. John.
7. While not providing specific comment on the calculation methodology behind the different industry levies proposed by FOS, SPAA believes there is merit in deferring the calculation methodology for the Financial Advisor sector until after the Future of Financial Advice (FOFA) and Stronger Super reforms have been finalised. SPAA considers the outcome of these reforms are likely to have a significant impact on the Financial Advisor sector and ultimately the compensation scheme levy for this sector.
8. In SPAA’s view, an essential feature of a last resort compensation scheme for the financial services industry is that the cost of compensation should to be funded by the industry sector from which the compensation claim arose. However, to manage the cost of compensation claims, the scheme should be sufficiently flexible to enable excessive compensation claims to be funded by a levy imposed on a linked or related industry sectors, but this levy should not be imposed directly on investors or consumers.

9. AFS licensees should be categorised and allocated to industry sectors with the “Fund Manager” sector sufficiently broad to include operators of Managed Investment Schemes.
10. SPAA believes such a scheme, if it existed prior to the Trio collapse, could have provided adequate but limited financial compensation to SMSF investors and other investors. Those investors under the current regime were generally not eligible for financial compensation for losses due to the fraud or theft.
11. The collapse of Trio has highlighted that insurance arrangements for AFS Licensees should be more prescriptive and that the role of ASIC as a regulatory body, in ensuring compliance with the Regulatory Guide (RG) 126 in Compensation and Insurance Arrangements for AFS licensees, should be more systematic and defined. However, while in SPAA’s view these measures may reduce the risk and improve the overall operation of the advice sector, in the absence of a last resort financial services compensation scheme, the potential for some investors to suffer financial losses without adequate access to compensation, will remain.

About SPAA

12. SPAA is the peak professional body representing the self managed superannuation fund (SMSF) sector throughout Australia. SPAA represents professionals, irrespective of their personal membership and professional affiliations, who provide advice to individuals aspiring to higher levels of participation in the management of their superannuation savings. Membership of SPAA is principally accountants, auditors, lawyers, financial planners, actuaries and other professionals.
13. SPAA is committed to raising the standard of professional advice and conduct in the SMSF sector by working proactively with Government and the industry. In doing so, SPAA has contributed to SMSF advisors providing a higher standard of advice to SMSF trustees. This in turn has enabled trustees to make more informed decisions addressing the adequacy, sustainability and longevity of their own retirement savings. SMSFs offer trustees greater control and flexibility and have become an integral part of the Australian Superannuation landscape by providing significant and viable options for managers, business owners, executives and retail operators alike.

Summary of SPAA recommendations

14. **Recommendation No. 1** – An industry based last resort compensation scheme should be introduced for the financial services sector with the following key features:
 - i. It should provide limited “last resort” financial compensation in situations where a client has suffered financial loss as a result of the misconduct or insolvency of a AFS licensee;
 - ii. The compensation should be funded by a levy imposed on the industry sector from which the compensation claim arose;
 - iii. The characterisation of industry sectors should be sufficiently broad to include Managed Investment Scheme providers;
 - iv. Compensation levies should be based primarily on past events;
 - v. The scheme should be sufficiently flexible to allow excessive compensation claims to be funded by a levy imposed on a linked industry sector.
15. **Recommendation No. 2** – The calculation of a compensation scheme levy for the Financial Adviser sector¹ should be deferred until after the FOFA and Stronger Super reforms have been finalised.

¹ As referenced by the Financial Ombudsman Service and Richard St. John Consultation Paper.

16. **Recommendation No. 3** – ASIC should undertake periodic and systematic maintenance of professional indemnity insurance policies held by AFS licensees.

Shortcomings of current compensation arrangements

17. At present, the current avenues for consumer compensation in the financial services industry are fragmented and range from government guarantees of bank deposits and insurance claims to a reliance on professional indemnity insurance.
18. In the financial advice sector a client of an AFS licensee who suffers a loss or damage arising from misconduct can seek redress through legal action. This generally requires the client to pursue an action for a breach of contract, or action in tort, or through a class action with other clients who have had similar experiences with the licensee.
19. Alternatively, retail clients of an AFS licensee can seek redress for misconduct through a less formal External Dispute Resolution scheme (EDR scheme) which meets ASIC approved standards and requirements. In the financial advice industry, the *Financial Ombudsman Service* (FOS) is the largest provider of dispute resolution services for disputes with financial advisers.²
20. An AFS licensee is considered to have committed an act of misconduct if they fail to exhibit the professional conduct required under Chapter 7 of the Corporations Act. Examples of misconduct under Chapter 7 include:
- Dishonest conduct;
 - Providing personal financial advice without first making reasonable inquiries about the client's personal circumstances;
 - Making false or misleading statements;
 - Providing false and misleading information;
 - Engaging in market manipulation.
21. Where FOS finds in favour of a consumer it makes an award that reflects the loss incurred up to the compensation cap. From 1 January 2012, the compensation cap will be \$150,000 if made for a claim against a general insurance broker and \$280,000 for other claims. These caps will be subject to indexation.
22. However, while an AFS licensee is contractually bound to honour an award for compensation it does not always follow that the licensee will have the financial capacity to honour an award. To reduce the risk that compensation claims by retail clients cannot be met by the relevant licensees due to the lack of available financial resources, licenses are required to carry professional indemnity insurance.
23. While professional indemnity insurance plays an important role in assisting ASF licensees to compensate clients, there are many limitations to the effectiveness of professional indemnity insurance. For example, if the licensee becomes insolvent the insurer will not honour any claims if the licensee's insurance policy has lapsed or been cancelled. Similarly, claims made after the licensee has ceased operating will not be honoured by the insurer unless adequate run-off cover exists. Claims resulting from fraud or theft committed by the licensee are typically excluded as an insurable event. These limitations and others were well documented in the recent consultation paper prepared by

² Review of compensation arrangements for consumers of financial services, consultation paper by Richard St. John, April 2011, Pg. 52.

Richard St. John on compensation arrangements for consumers of financial services and the submission prepared by FOS in response to that consultation paper.³

24. Apart from the EDR schemes and the professional indemnity insurance requirements of licensees, separate statutory last resort compensation arrangements also cover a number of the financial services sectors. For example, the Financial Claims Scheme provides depositors of Approved Deposit Institutions (ADIs) and general insurance policyholders with access to funds in the event of the failure of such a financial institution. Similarly Trustees of APRA regulated superannuation funds can apply to the Minister for a grant of financial assistance if the superannuation fund incurs a loss as a result of fraudulent conduct or theft and a future conviction can be obtained.⁴
25. There is no last resort compensation scheme for consumers of financial advice and investors in the funds management industry. For investors in these sectors, the only avenue of compensation in the event of licensee misconduct is the EDR scheme which if successful may require the licensee to make a claim under their professional indemnity insurance policy. Therefore, the payment of compensation in these circumstances is dependent on the financial viability of the licensee and the professional indemnity insurance policy maintained by the licensee.
26. As previously outlined due to the illegal nature of fraud and theft it is not an insurable event under professional indemnity insurance policies. This means consumers of financial advice and investors in the funds management industry who are victims of fraud or theft perpetrated by the licensee will typically receive little or no compensation. The absence of professional indemnity cover in these circumstances is exacerbated by the fact that the option of private legal action is rarely available. Commonly the whereabouts of perpetrators who commit fraud or theft are unknown which makes legal action unviable. Table 1 in Appendix A provides a summary of the last resort compensation arrangements currently applicable in the different financial services sectors.
27. FOS is a small claims tribunal which had a previous claim limit of \$50,000, the absence of an appeals process for AFS licensees and a recent increase in the maximum value of claims which can be submitted to FOS, has resulted in a significant reduction in the number of professional indemnity insurers.
28. There is also some evidence that many investors are not aware of the available avenues of compensation and investors commonly avoid instigating individual private legal action partly because they blame themselves and partly because they were unwilling to risk losing more money by taking legal action.⁵
29. The absence of a last resort compensation scheme in some sectors of the financial services industry, means that in the event of misconduct, the sectors that do have a last resort compensation scheme may incur disproportionately high amounts of compensation levies for misconduct committed in other sectors. As illustrated in the Trio case, members of APRA regulated superannuation funds incurred a compensation levy for misconduct committed in the advice and funds management sector.

Relationship between SMSF arrangements and regulatory coverage

30. Section 761G(6) of the *Corporations Act 2001* (the Act) discusses when financial services that relate to superannuation products are provided to a person as a retail client. Section 761G(7) of the Act sets out

³ Review of compensation arrangements for consumers of financial services, consultation paper by Richard St. John, April 2011; Review of compensation arrangements for consumers of financial services, submission prepared by the Financial Ombudsman Service, May 2011.

⁴ SIS s23.

⁵ ASIC report 240 – Compensation for retail investors: the social impact of monetary loss, May 2011. Pg. 9.

when financial services are provided to retail clients if the financial service does not relate to a superannuation product. The words 'relates to' have a wide meaning.

31. In ASIC's view, a financial service can relate to a superannuation product under s761G(6) in circumstances where financial services are provided to the trustees of superannuation funds rather than superannuation fund members. This is the case even though those trustees are themselves the issuers of superannuation products.
32. However, s761G(6) does not apply in relation to the trustees of superannuation funds that meet the \$10 million net asset test in s761G(6)(c). This test is applied to the asset value of the fund at the time the service is provided and not to the trustee.
33. Section 761G(6) therefore ensures that the trustee of a small net asset value fund, including a SMSF, is treated as a retail client for the provision of financial services relating to that superannuation fund. ASIC's view is that s761G(6) will apply in these circumstances to the exclusion of the general wholesale client test in s761G(7).⁶
34. Consumers of a financial service, including members of a SMSF with fund assets under \$10 million, who suffer a financial loss as a result of the misconduct or insolvency of an AFS licensee have a statutory right to seek compensation under the Act for ADI and general insurance. In the case of a SMSF, if the SMSF suffers a financial loss as a result of the failure of an ADI or general insurance provider (including situations which may involve theft or fraud), the SMSF can seek compensation from the Financial Claims Scheme.⁷
35. However, if the SMSF suffers a financial loss as a result of the misconduct or insolvency of an AFS licensee the SMSF does not have access to a last resort compensation scheme and must seek compensation via the EDR scheme. While a licensee is contractually bound to honour an award for compensation it does not always follow that the licensee will have the financial capacity to honour that award.
36. If the licensee does not have the financial capacity to honour the award the only avenue for compensation is for the SMSF trustees to take legal action against the AFS licensee. However, in the event of theft or fraud, it is typically the case that the whereabouts of the perpetrators cannot be determined and therefore the likelihood of the SMSF trustees receiving compensation is remote. Even if the whereabouts of the perpetrators can be determined, the financial viability of the perpetrators is likely to make any claim for compensation unviable.
37. Under Part 23 of the *Superannuation Industry (Supervision) Act 1993* a trustee of an APRA-regulated superannuation fund can apply to the Minister for a grant of financial assistance if the superannuation fund incurs a loss as a result of fraudulent conduct or theft. The Minister can involve the grant if there is a known future conviction. Part 23 specifically excludes SMSFs from being able to apply for financial assistance under that Part.
38. While a Part 23 ministerial grant of compensation may be appropriate for APRA regulated funds, it is unlikely to be an appropriate means of compensation in the broader event of misconduct or insolvency of an AFS licensee. The regularity of such claims and discretionary nature of Part 23 means an alternative funding method would be needed for such a scheme.

⁶ ASIC QFS 150.

⁷ The Financial Claims Scheme (FCS) was established in October 2008 to provide depositors of ADIs and general insurance policyholders with access to funds in the event of the failure of such a financial institution. FCS is administered by APRA with its day to day costs met through the APRA levy on prudentially regulated financial institutions.

39. In SPAA's view there is inadequate protection against misconduct and insolvency of an AFS licensee for those who invest through SMSFs as opposed to other investment vehicles. SMSF members are mostly retail investors, similar to ordinary investors in the market, who are less able to absorb investment losses when compared with larger funds of the kind regulated by APRA.⁸
40. SPAA acknowledges that SMSF investors make a consensual decision to make their own investment decisions but in SPAA's view that should not result in SMSF members being left to fend for themselves if they lose money due to the misconduct or insolvency of an AFS licensee or product provider. This argument is further supported given the highly regulated environment under which the financial services sector operates in Australia. The advent of fraud and theft highlight weaknesses in that system.

The case for a last resort financial services compensation scheme

41. Based on its own direct experiences FOS has long held concerns about the circumstances in which consumers of financial services suffer losses which they are unable to recover, even when they have a court award or an Ombudsman determination in their favour.⁹
42. The Trio collapse highlighted deficiencies with the current compensation arrangements in particular the drawbacks of relying on EDR schemes and mandatory professional indemnity insurance cover. Other notable examples have included Westpoint and Storm where many investors incurred significant financial losses due to the misconduct of financial advisers and product providers.
43. In February 2009 the Parliamentary Joint Committee on Corporations and Financial Services recommended that the Government investigate the costs and benefits of a statutory compensation scheme. 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.¹⁰ Thirdly, the loss experience can have a corrosive effect on trust in the financial system.¹¹

FOS's proposed financial services compensation scheme

44. FOS has previously proposed the establishment of an industry based FSCS for retail clients and has conducted extensive research into the need for such a scheme.¹² SPAA supports the FOS proposal, with some modifications, and considers the introduction of such a scheme would not only fill the compensation gaps which currently exist but would also improve consumer confidence and trust in the financial services sector.
45. The scheme proposed by FOS is industry based and industry funded and would provide adequate (but limited) compensation to consumers as a last resort. It is not proposed that such a scheme would replace the role of professional indemnity insurance and would be a last resort compensation scheme only. FOS has designed an FSCS with the following key features:

⁸ Regina v Shawn Darrell Richard, 2011, NSWSC 866, Justice P. Garling.

⁹ Review of compensation arrangements for consumers of financial services, submission prepared by the Financial Ombudsman Service, May 2011. Pg. 4.

¹⁰ Many investors who had not considered IDR and EDR schemes knew nothing about them. In many other cases compensation amount being claimed exceeded the amount that the EDR scheme could award.

¹¹ ASIC report 240 – Compensation for retail investors: the social impact of monetary loss, May 2011. Pg. 8.

¹² Review of compensation arrangements for consumers of financial services, submission prepared by the Financial Ombudsman Service, May 2011. Pg. 4.

- Industry based and funded;
- Stakeholder representation;
- Legislative support;
- Limited but sufficient last resort compensation; and
- Cost attributed to responsible industry sector.

46. The scheme proposed by FOS will quarantine the funding of claims into the industry sector(s) which have given rise to the need for compensation and for this purpose licensees have been categorised and allocated to industry sectors (General insurance, Insurance Brokers, Financial Advisers, Fund Managers). It is envisaged that a compensation levy imposed on an industry sector would be capped at 1% of the revenue of that sector.¹³ In SPAA's view, and to avoid doubt, the "Fund Managers" industry sector should be sufficiently broad to include operators of Managed Investment Schemes.
47. It is also envisaged that if the compensation costs are likely to exceed the limit (1%) of that industry sector, then the excess would be allocated to a "linked" industry sector. For example, if the compensation claim was the result of misconduct in the Financial Adviser sector, and if the compensations costs exceed 1% of that sector's revenue, then the excess could be allocated to the Fund Managers sector as a linked industry sector.¹⁴
48. SPAA supports this approach but considers where the misconduct arises in the Fund Managers sector (for example due to the failure or collapse of a Managed Investment Scheme provider) compensation costs should be levied on that industry sector first with any excess over 1% allocated to the Financial Advisers sector as a linked group. We understand this is also the intention of the FOS scheme. SPAA believes this approach will ensure the industry sector in which the misconduct or insolvency occurred will always be called on first to fund the compensation claim.
49. SPAA acknowledges that the levy funding model proposed by FOS has been the subject of extensive discussion with industry bodies, consumers, regulators and other parties. While not providing specific comment on the calculation methodology behind the different industry levies, SPAA believes there is merit in deferring the calculation methodology for the Financial Adviser sector until after the FOFA and Stronger Super reforms have been finalised.
50. SPAA considers that the introduction of scaled advice, the new best interest duty obligation, the removal of the accountant's exemption and the introduction of higher competency standards for financial advisers, which are all being considered as part of the FOFA and Stronger Super reforms, are likely to impact on the Financial Advice sector and ultimately on the level of a compensation scheme levy for this sector. SPAA would support consideration of the implemented measures once the FOFA reforms have been introduced. SPAA expects these measures will reduce the risk of misconduct in the Financial Advice sector.
51. The compensation levy proposed by FOS comprises an annual standard compensation levy to cover the costs of projected annual compensation costs together with a special compensation levy to enable the scheme to meet the costs of compensating claimants in the event of significant losses arising from one or more defaults. SPAA considers that a compensation levy should be based primarily on past events but acknowledges that an annual low level compensation levy based on anticipated claims is necessary to guard against the possibility that one industry sector may have insufficient funds to honour their compensation claims payable under the scheme.

¹³ Review of compensation arrangements for consumers of financial services, submission prepared by the Financial Ombudsman Service, May 2011. Pg. 4

¹⁴ Review of compensation arrangements for consumers of financial services, submission prepared by the Financial Ombudsman Service, May 2011. Pg. 4

52. SPAA notes that the maximum compensation sums payable under the proposed FOS scheme to a consumer is \$204,000. While a higher maximum compensation sum is desirable, the benefits of increasing this maximum sum need to be balanced against the increased cost of the compensation levy which may need to be imposed on each industry sector and possibly ultimately borne by all investors in that sector. In SPAA's view consideration should be given to increasing the maximum compensation sum to \$280,000 and indexing it thereafter so that the maximum sum payable equates to the cap which will apply to FOS EDR claims from 1 January 2012.
53. In SPAA's view, if the FSCS was in place prior to the Trio collapse, such a scheme would have provided appropriate compensation to SMSF investors and other similar investors who under the current regime received little or no compensation.

ASIC administration of the adequacy of professional indemnity insurance cover

54. ASIC's general approach to insurance arrangements of FSR licensees relies on licensees self-assessing the adequacy of their professional indemnity cover taking into account of the guidance in RG 126. ASIC does not vet the terms and conditions of a licensee's insurance cover but puts the onus back on licensees to ensure their professional indemnity cover complies with their overall risk management processes.
55. Licensees are not required to provide ASIC with a copy of their professional indemnity insurance policy but new licensees are required to provide information about their insurance cover and a certificate of currency as part of the license application process.
56. Once a license is granted, the licensee's insurance cover is not subject to annual or other periodic review. However, a licensee is required to notify ASIC if they no longer are able to meet their licence obligations including the requirement to have adequate professional indemnity insurance.¹⁵
57. SPAA supports a periodic and more systematic approach by ASIC in the monitoring and assessment of insurance policies held by licensees. At the very least, SPAA believes that licensees should be required on an annual basis to show how their insurance arrangements satisfy the requirements as set out in RG 126. SPAA also believes Managed Investment Scheme providers should be required to join an ASIC approved EDR scheme as a condition of their registration.
58. SPAA also supports the creation and promotion of standard professional indemnity insurance policies as a way of reducing the transaction costs and associated risks for licensees and consumers. Standard insurance policies would also encourage insurers to develop policies that can cover similarly situated licensees. Standard insurance policies may also address the general lack of run-off cover which exists in the financial services sector and which is a significant weakness in the reliance on professional indemnity insurance.
59. In SPAA's view while these measures may reduce the risk and improve the overall operation of the advice sector, in the absence of a last resort financial services compensation scheme, the potential for some investors to suffer financial losses without adequate access to compensation, will remain.

¹⁵ Review of compensation arrangements for consumers of financial services, consultation paper by Richard St. John, April 2011, Pg. 24.

Wholesale versus retail

60. SPAA believes that irrespective of the financial service provided, in the event of misconduct or insolvency consumers should have access to a last resort compensation scheme. Consistent with our view that SMSF members who have chosen to make their own investment decisions should not be left to fend for themselves, the same applies to investors who are classified as wholesale investors. The consumer protection measures which an investor chooses to forgo as a wholesale investor do not or should not in our view extend to situations where the investor has suffered a financial loss as a result of the misconduct or insolvency of an AFS licensee.
61. SPAA is aware that as part of the FOFA reforms, the Government is reviewing the appropriateness of the distinction between wholesale and retail clients.¹⁶ Therefore, while there may be merit in extending a last resort compensation scheme to wholesale investors, SPAA considers this decision should be deferred until this aspect of the FOFA reforms has been finalised.

Further Information

We would be pleased to provide you with any further information in support of our submission.

Contacts:

SMSF Professionals' Association of Australia Limited (SPAA)
ACN: 103 739 617

Address:

SPAA House
Level 1, 366 King William St
Adelaide SA 5000

Contact Numbers:

Tel: (08) 8205 1900
Facsimile: (08) 8212 5993

Mrs. Andrea Slattery
Chief Executive Officer

Mr. Peter Burgess
Technical Director

¹⁶ Future of Financial Advice - Wholesale and retail clients options paper, January 2011.

Appendix A - Compensation arrangements applicable to financial services licensees

<i>Financial services licensees</i>								
Financial services providers requiring a License	Financial advisers	Insurance brokerage	Securities, futures or derivatives brokers	Superannuation funds	Provision of managed investments	Provision of insurance	Provision of banking services	Provision of credit
Default compensation requirements	Section 912B compensation requirements apply to all licensees							Additional requirement for compensation under the National Consumer Credit Protection Act 2009
Nature of compensation arrangements	Professional indemnity insurance (or alternative approved by ASIC)					Self insurance (as prudentially regulated entities)		Professional indemnity insurance, self insurance (for prudentially regulated entities) or alternative approved by ASIC
Grounds for and resolution of claims	Breach of conduct and disclosure requirements Determined by court, internal dispute resolution or external dispute resolution processes							Additional grounds under National credit code for breach of responsible credit conduct
Other arrangements			National guarantee fund and other regimes set up by providers of financial markets	Ministerial grant of financial assistance to superannuation fund trustee for loss from fraud or theft		Financial Claims Scheme for loss by depositors or policy holders due to insolvency of ADI or general insurer		

Source: Review of compensation arrangements for consumers of financial services, Consultation Paper by Richard St. John, Pg. 40.