

SECURITIES EXCHANGES GUARANTEE CORPORATION LIMITED (SEGC)

**SUBMISSION ON THE POSITION PAPER ON
COMPENSATION FOR LOSS IN THE FINANCIAL SERVICES SECTOR**

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Executive Summary

SEGC is pleased to have the opportunity to make a submission in relation to the position paper on compensation for loss in the financial services sector.

SEGC agrees with the proposal that financial services licensees be required to have professional indemnity insurance. Alternatives to professional indemnity insurance may also be appropriate if it can be demonstrated that they provide comparable consumer protection to professional indemnity insurance.

In relation to market compensation arrangements, SEGC strongly supports limiting payments from the National Guarantee Fund (NGF or the Fund) by imposing monetary caps and submits that regulations should impose a cap of \$500,000 on the amount of compensation to which a person is entitled in respect of a claim on the NGF. SEGC supports in principle the capping of levies to fund the NGF but only if payments from the NGF are also capped, as SEGC should not have a limitation on its ability to raise funds while its liability for claims is unlimited. SEGC considers that amendments are required to address the overlap in compensation provided by different market compensation arrangements and the lack of uniformity between those arrangements.

These and other matters are discussed in more detail below.

Professional indemnity insurance for financial services licensees

SEGC agrees with the proposal to amend section 912B to require financial services licensees to have compensation coverage, such as professional indemnity insurance, for:

- acts, errors or omissions for which the licensee is legally liable and such conduct of its representatives for which it is responsible (but excluding civil and criminal penalties imposed on the licensee);
- in the course of:
 - dealing on behalf of;
 - advising; or
 - providing custodial or depository services;to retail clients on financial products.

However, it may not be appropriate to limit the insurance coverage to conduct within the licensee's licence, given that conduct which causes loss to a client may well be in breach of the licence.

SEGC does not consider that any particular statutory obligation should be exempt from insurance coverage on the basis that coverage may encourage non-compliance with the obligation. Insurance should be in place to provide funds to meet claims by clients where the loss results from a breach of a statutory obligation. Further, it is not clear that insurance coverage in relation to statutory obligations would encourage non-compliance. Financial services licensees are required to comply with financial services laws, which are defined to include any Australian legislation that covers conduct relating to the provision of financial services, and ASIC may suspend a licensee (after offering a hearing) for failure to comply with this obligation¹. This, and other legal consequences of a failure to comply with a statutory obligation, should deter non-compliance regardless of the insurance coverage in place.

¹ Corporations Act, sections 912A and 915C

Alternatives to professional indemnity insurance may be appropriate if it can be demonstrated that they provide comparable consumer protection to professional indemnity insurance. Any such arrangement should ensure that there will be adequate funds available to meet claims by clients. Similarly, if bodies with high capitalisation can gain an exemption from the requirement to have insurance, the test to qualify for that exemption should ensure that those bodies have adequate funds to meet claims by clients, even in circumstances of financial stress.

The position paper states that the requirement that licensees have professional indemnity insurance (or similar arrangements) and the requirement that markets have compensation arrangements under Part 7.5 of the Corporations Act should complement each other as the administrator of a Part 7.5 arrangement is subrogated to the rights of the claimant against the financial services licensee which is backed by insurance. Consistent with this, it will be important to ensure that insurance will cover all losses which may give rise to claims on compensation arrangements. Further, in considering whether alternatives to professional indemnity insurance are adequate and whether some bodies should be exempt from the requirement to have insurance the availability of funds to meet subrogated claims should be a relevant factor.

Market compensation arrangements

Limiting payments from the NGF

SEGC strongly supports limiting payments from the NGF by imposing monetary caps. At present, there are no caps on payments from the NGF other than a cap of \$11.2 million in relation to claims for property entrusted to a dealer that becomes insolvent. Hence, the NGF is exposed to potentially unlimited liability for claims.

As discussed in SEGC's submission of November 2002 a cap on payments would:

- ensure the structural soundness of the Fund and facilitate the actuarial calculation of the amount required by the Fund;
- reduce the moral hazard whereby clients take unacceptable risks in the knowledge that there are no limits on the compensation available;
- be consistent with external dispute resolution schemes which may impose monetary limits on claims and reduce the possibility of forum shopping;
- be consistent with international compensation schemes in the financial services industry which, as far as SEGC is aware, all impose monetary limits on claims.

Further, a cap on payments would be consistent with compensation arrangements under Division 3 of Part 7.5 of the Corporations Act to the extent that the rules for those arrangements may impose an upper limit on the amount of compensation to which a person is entitled in respect of a claim².

SEGC considers that a cap of \$500,000 on payments from the NGF would be appropriate. A cap of this amount would not result in any substantial reduction in investor protection by the NGF. As discussed in SEGC's submission of November 2002 a cap of \$500,000 would have limited payments from the NGF on only 4 occasions since the Fund's inception in 1987. Further, a cap of \$500,000 is generous in comparison with most other international and domestic compensation schemes.

The submissions made in response to the Issues and Options Paper on Compensation for Loss in the Financial Services Sector indicate that there is widespread support for limiting payments from a compensation scheme either by imposing a monetary cap on payments from the scheme or by

² Corporations Act, section 885E(3)

restricting access to the scheme to retail clients, or both. While these submissions do not relate specifically to the NGF they support the general view that there should be a limit on claims on a compensation scheme.

The Corporations Act provides that regulations may impose an upper limit on the amount of compensation to which a person is entitled in respect of a claim in particular circumstances³. For the reasons set out above, SEGC submits that regulations should impose an upper limit of \$500,000 on the amount of compensation to which a person is entitled in connection with a claim on the NGF.

The capping of claims may diminish NGF protection in relation to clients of an intermediary (e.g. financial planner) in circumstances where the intermediary, and not the original client, is the client of a broker (referral business). The intermediary could make a claim on the NGF, thereby giving the clients indirect protection, but only up to the amount of the cap. SEGC suggests that in these circumstances the intermediary should be required to disclose to clients that they have no direct NGF protection and that any claim by the intermediary is subject to a cap. Note that if it was proposed to allow larger payments from the NGF in cases involving referral business a special cap should be imposed on the total amount that could be paid in relation to one intermediary.

Capping levies on participants to fund the NGF

The position paper seeks submissions as to whether a limitation on SEGC's power to levy participants to fund the NGF is appropriate to assist ADIs to meet APRA requirements.

SEGC supports in principle the capping of levies on participants. However, it submits that levies should not be capped while payments from the NGF remain uncapped⁴. As discussed above, at present there is no limit on payments from the NGF (other than for claims for property entrusted to an insolvent broker) and hence the NGF is exposed to potentially unlimited liability for claims. It is therefore theoretically possible for a single claim or a series of large claims to wipe out all funds held by the scheme. This is an unsatisfactory situation as it undermines the ongoing structural soundness of the NGF. This problem would be compounded if levies on participants were capped as this would result in a situation where SEGC is exposed to unlimited liability for claims while its ability to raise funds is limited.

Assuming that claims on the NGF are capped, it is then necessary to consider what cap on levies would be appropriate. The position paper suggests that one possible cap would be the value of each participating organisation's transactions over the previous year as a percentage of the total value of transactions covered by the NGF, multiplied by the number of dollars the NGF is below its minimum. However, this type of cap may give rise to the following difficulties in practice:

- Where one or more participants have become insolvent they will not be able to meet any levy by SEGC. Further, if participants have resigned since the previous year they will not be obliged to pay a levy. Hence, a levy based on a participant's proportion of the total transactions in the previous year may not be adequate to restore the NGF to the minimum amount. This is not consistent with the original intention of the levy power, which was to allow SEGC to maintain the minimum amount in the Fund⁵.
- It is not clear how the cap would be applied to new participants (who were not participants in the previous year) or to participants who merge. Further, the total value of a participant's

³ Corporations Act, section 888C(3)

⁴ Note that it was ASX rather than SEGC that requested a limitation on levies in its initial submission (referred to in paragraph 312 of the position paper).

⁵ Explanatory Memorandum, Australian Stock Exchange and National Guarantee Fund Bill 1987, paragraph 69

transactions in the previous year may not be an accurate indication of its market share in the year of the levy.

- It is not clear whether “transactions covered by the NGF” are intended to be limited to reportable transactions or to extend to other transactions to which NGF protection may be relevant. The value of transactions other than reportable transactions would be very difficult to determine. Further, if access to the NGF is limited to retail clients (as discussed in the position paper) then transactions covered by the NGF would be limited to transactions by retail clients. The value of these transactions for each participant would be difficult to determine.

In view of these difficulties, SEGC considers that it would be preferable that the cap be calculated simply by reference to the amount needed to restore the fund to the minimum amount in any one year. On this approach SEGC could impose a levy (or levies) in any year equal to the amount required to restore the Fund to the minimum amount. This would be consistent with the original intention of the levy power.

The levy would be calculated, as under the present arrangements, in a manner determined by SEGC. SEGC could, for example, impose a uniform levy on all (or a class of) participants. Alternatively, SEGC could calculate the levy (up to the amount of the cap) on some other equitable basis (e.g. a transaction/market share based approach). Note that if a levy was imposed to raise a significant amount it is more likely that SEGC would take the latter approach so as not to cause financial hardship to smaller participants.

It is important to ensure that any cap on levies will still allow SEGC to raise sufficient funds to meet claims and support the ongoing structural soundness of the Fund. Hence, it may be necessary for any amendments in relation to a cap on levies (or formula to determine a cap) to be subject to actuarial review once a decision is reached as to how payments from the NGF are to be limited.

Allocation of transactions to a particular market

The position paper states that the Government is willing to consider amendments to the provisions which attempt to allocate a particular transaction to a particular market (in the context of compensation arrangements) and in particular problems in relation to section 885D of the Corporations Act. As stated in SEGC’s submission of November 2002, SEGC considers that amendments are required to address the overlap between compensation arrangements under Part 7.5 Division 3, which apply to markets other than ASX, and compensation arrangements under Part 7.5 Division 4 (i.e. the NGF), which apply to the ASX market.

Division 3 arrangements apply to losses which arise when a client gives money or other property, or authority over property, to a market participant “in connection with effecting a transaction, or proposed transaction, covered by provisions of the operating rules of the market relating to transactions effected through the market” and the client suffers loss as a result of defalcation or fraudulent misuse of that money or property (section 885C(1)). Section 885D provides that if a person suffers a loss which could be connected with 2 or more financial markets and it is not apparent from that person’s instructions to the participant or the participant’s usual business practice which of those markets the participant would use, then this is not a loss covered by the compensation arrangements under Division 3.

The NGF applies to losses in relation to contract completion, unauthorised transfer and property entrusted to an insolvent participant. However, unlike Division 3 arrangements, compensation for unauthorised transfer and entrusted property claims is not restricted to transactions in connection with the ASX market.

If a financial services licensee is a participant of both a non-ASX market and the ASX market there will be an overlap between the Division 3 compensation arrangements of the relevant non-ASX market and the NGF in 2 circumstances:

- where the conduct constitutes a fraudulent misuse/unauthorised transfer of securities; and
- where there has been a defalcation/fraudulent misuse of property entrusted to the participant, and the participant has subsequently become insolvent.

As a result of this overlap an unauthorised transfer or property entrusted claim could be made on the NGF, rather than the Division 3 compensation arrangement of the non-ASX market, even if the securities the subject of the claim are not ASX securities and the defalcation or fraudulent misuse occurred in relation to the participant's activities on the non-ASX market.

In order to address this problem, SEGC submits that the following limitations should be placed on NGF compensation arrangements:

- protection in relation to unauthorised transfers should apply only in relation to securities that are traded on the ASX market and should not apply if the transfer was effected on a market other than ASX; and
- protection in relation to property entrusted to a participant that becomes insolvent should apply only in relation to property that was entrusted to or received by the participant in connection with effecting a transaction, or proposed transaction, on the ASX market (or the CS facility to be operated by Australian Clearing House) or through a service offered by ASX.

Problems may also arise in relation to section 885D. Under this section, if a loss could be connected to 2 or more markets all of which have Division 3 compensation arrangements, but it is not clear which, the client would not be entitled to compensation. If the loss could be connected to 2 or more markets, one of which has Division 4 compensation arrangements (i.e. the ASX market), but it is not clear which, the client may be entitled to compensation from the NGF. These situations could arise where the loss relates to the misappropriation of money or property held by a participant for a client in circumstances where the client is trading on more than one market.

The uncertainty resulting from section 885D and the possible gap in compensation is not in the interest of clients of market participants. It would be preferable if the legislation provided that if the loss is connected to 2 or more markets, but it is not clear which, then the compensation arrangements of the relevant markets should be jointly liable to pay any compensation (provided that the compensation arrangements would otherwise cover the loss). In this circumstance the administrators of the compensation arrangements could jointly determine the claim.

A related problem which was also raised in SEGC's submission of November 2002 is the lack of uniformity in the claims provisions in Division 3 and Division 4. As noted above, Division 3 compensation arrangements are required to provide compensation in relation to defalcation or fraudulent misuse of money, property or authority over property by a participant. Division 4 compensation arrangements (i.e. the NGF) are required to provide compensation in relation to contract completion, unauthorised transfer and property entrusted to an insolvent participant. The differences in the protection provided by Division 3 and Division 4 arrangements are likely to result in client confusion and inequitable results. To avoid these problems SEGC submits that there should be uniform minimum standards for the protection offered by market compensation arrangements. Further, it would be preferable if there were more flexibility to modify the NGF

claims provisions to provide coverage for any new products traded on the ASX markets. If it is not considered appropriate to deal with these issues at present SEGC requests that they be reviewed in the future.

Information about compensation arrangements

SEGC considers that the best way to ensure that consumers do not have false expectations about compensation arrangements is to make information about those arrangements publicly available, as required under section 792I of the Corporations Act. Information about the NGF is made available to the public and/or clients of participants, by the following means:

- Information about the NGF is available on the websites of both ASX and SEGC. Further, the ASX website contains information as to what a client should do if they have a complaint against a broker, which includes information about the NGF.
- SEGC provides information, including a copy of an information booklet, free of charge to persons who contact SEGC or ASX seeking information about investor compensation.
- Under the SCH Business Rules a Sponsorship Agreement between a broker and a client must include a notification to the client that in the circumstances specified in the legislation the client may make a claim on the NGF for compensation.

SEGC submits that it would also be appropriate to require the Financial Services Guide, which financial services licensees are obliged to give to their retail clients⁶, to include information on compensation arrangements. The Financial Services Guide is required to include information about the dispute resolution system that covers complaints by persons to whom the licensee provides financial services, and about how that system may be accessed⁷. There could be a similar requirement in relation to information on compensation arrangements. To avoid false expectations, the information provided should specify which services are covered by a compensation scheme and which services are not covered. Further, it would be useful if the information was provided to clients on a regular basis (e.g. yearly).

Other matters

The position paper refers to the case involving Thompson Brindal/Retireinvest relating to claims that clients lost around \$17 million as a result of unauthorised trading and states that it is understood that a related company compensated clients and then sought reimbursement from the NGF. SEGC notes that the claims on the NGF were ultimately settled for an amount of \$300,000. Some of the issues relating to these claims are discussed in Securities Exchanges Guarantee Corporation Ltd v Aird & Ors (2001) 161 FLR 420.

⁶ Corporations Act, section 941A

⁷ Corporation Act, section 942B