CHOICE proposal for Compensation Scheme for market linked investment products (including property trusts and cash management trust accounts)

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Key Features

1. *Provides for compensation for consumer losses where licensees have acted contrary to the law and are unable to pay compensation eg due to insolvency*

2. *Covers losses sustained by retail clients who deal with licensed intermediaries and licensed product issuers.*

This would therefore cover the activities of:

- Financial planners
- Investment adviser
- Stockbrokers
- Insurance brokers
- Operators of managed schemes
- Operators of superannuation funds[1]; and
- Operators of general insurance companies.

3. *Covers all breaches of financial services law and where licensees act outside their license conditions.*

We want to see the broadest range of activities covered by the compensation regime. In out 2002 submission we said "unless consumers can have confidence that licensees will meet all of their obligations imposed by the Corporations Law then confidence in the market will deteriorate." Turns out we were right. The compensation system as a whole must ensure that consumers can obtain compensation for all forms of misconduct – essentially any breach of financial services law that leads to a consumer loss.

4. *Applies across the market*

5. *Puts investors back in the position they would have been in if they had not suffered the loss flowing from the licensee's breach of the law.*

6. *Provides a maximum guarantee up to the retail client limit $500,000.*

7. *To minimise risky behaviour by clients as a result of the compensation scheme, payouts would be tiered and capped with only the first portion of the loss fully compensated.*

[1] Certain superannuation fund losses such as trustee fraud are already covered by a government guarantee that involves levying other super funds where necessary. This protection does not apply to self managed superannuation funds.

Some questions answered

Are there international precedents for such a scheme?

The UK Financial Services Compensation Scheme (http://www.fscs.org.uk) is a last resort scheme very similar to the one we propose. It is one of the reasons that the UK has become a centre for financial services and part of the UK government's 2005 strategy to have worlds best practice consumer regulation by 2008.

Will industry support scheme based on funding through a levy?

First – the scheme is about compensating consumers where there has been wrongdoing – not protecting them from risk. It is not designed to please industry.

Second - funding the scheme through a levy would be far cheaper for the industry than the ongoing reputational damage and loss of confidence respected funds suffer from events such as the collapse of Westpoint or more recently from the freezing of investor funds.

If the scheme is focussed on wrong doing by advisers (as in Westpoint) shouldn't it be limited to advisers?

There are a number of problems with separating claims against the conduct of intermediaries from issuers. Intermediaries are essentially the distribution arm of issuers and issuers provide them with considerable support and training. Consumer claims could arise out of matters that were a result of flawed servicing by an issuer including flawed product advice, training or even inherently flawed products or any combination of these. Who then should be liable for a consumer claim – the intermediary or issuer? It would not be acceptable for such claims to fall through the cracks.

Additionally there have been cases of consumers being misled by products sold directly by manufacturers.

Similarly, if arrangements cover only intermediaries and not issuers where does the client seek redress if they purchase a product through an intermediary but the issuers fails after receipt of the funds but before issue of the product? Would a claim against the intermediary succeed? Would it be fair if it did? For these and other reasons we have recommended broadening the scope of this review to include some product issuers (see also Consumer Recommendation 1).

Wont advisers and savvy clients be able to game the system? And won't it push advisers into recommending and consumers into investing in more risky investments than they should?

These so called 'moral hazard' problems can be dealt with through scheme design.

The argument is that licensees and consumers will take less care if a guarantee exists and may even induce both to undertake more risky behaviour ie in the case of

consumers to more risky licensees and licensees may also behave badly ie not conduct proper due diligence on investments that pay high commissions (but as we know this happens without a compensation fund/guarantee scheme).

However moral hazard arguments assume consumers have the ability to assess licensees – their financial position, their competence and trustworthiness of staff. Moral hazard is usually addressed in compensation/guarantee schemes by sharing the losses hence the tiering and cap on the payments. They also exclude those likely to be in the know ie family members, business associates and often rule out transactions designed to take advantage of the guarantee eg artificial transactions undertaken just before collapse.
We reject moral hazard arguments that imply that ordinary consumers will take less care in choosing financial products because of the existence of a compensation fund and may even gravitate towards risky licensees. This assumes consumers have access and are able to assess information about a licensee's financial position, competence and trustworthiness, contrary to the evidence. Research by Bateman has found that information asymmetries on the consumer/investor side mean that investors lack the information to assess and manage investment risks and make choices between funds based on costs.

The moral hazard argument also assumes consumers are aware of the existence of compensation schemes, contrary to the evidence. Research into consumer awareness of EDR schemes consistently suggests that consumers stumble on the schemes at the point that they have claims. Most are referred by scheme members when they remain dissatisfied with the outcome of an internal disputes procedure (as required by the rules) or find them in the Yellow Pages. Virtually none have prior knowledge.

What losses would be covered and how would they be measured?

The challenge in designing a compensation scheme is to respect the fact that the investment is meant to be more risky than a bank deposit. The answer is to focus on the impact of the misconduct by the financial adviser or fund; not to shield consumers from ordinary market risk.

The fund should be largely directed to consumers who are least able to sustain loss and should be designed to provide substantial cover for loss those consumers.

Compensation awards should aim to put the consumer in the position they would have been in if the misconduct had not occurred. *This does not mean putting them in the pre-loss situation but putting in the position they would be in at the time the claim is settled had the misconduct not occurred.* By definition this requires interest payments. It also includes some matters that might be construed as consequential loss eg a house burning down uninsured as a result of a failure by a broker. A discretion should be given to the scheme to allow the scheme to make the necessary award.

There will be claims where it is appropriate that the products are restored. In other cases the appropriate award would be equivalent monetary value. It will depend on the circumstances. Consumers should be given a choice. In the case a claim arising out of stolen investment monies it may be reasonable to return the dollar value of any

premiums plus interest over the relevant term. In other cases consumers may be happy for the fund to return to them the shares they had instructed their broker to buy.

The scheme should not account to clients for profits but should pay interest on monetary awards. Where the award is in relation to an investment product compound interest should be paid. The cost of pursuing claims should be recoverable and it may be appropriate to take into account clear cases of contributory conduct of a claimant to a loss.