Financial Accountability Regime Bill 2021and Financial Services Compensation Scheme of Last Resort Levy Bill 2021 and related bills

FSC Submission to Senate Economics Committee
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FINANCIAL SERVICES COUNCIL

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1. About the Financial Services Council

The Financial Services Council (FSC) is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services.

Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, life insurers and financial advisory networks.

Our Supporting Members represent the professional services firms such as ICT, consulting, accounting, legal, recruitment, actuarial and research houses.

The financial services industry is responsible for investing $3 trillion on behalf of more than 15.6 million Australians.

The pool of funds under management is larger than Australia's GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world.

2. Part A - Financial Accountability Regime

2.1. Executive Summary

The FSC welcomes the opportunity to make a submission to the Senate Economics Legislation Committee Inquiry into Financial Accountability Regime Bill 2021 [Provisions] and Financial Services Compensation Scheme of Last Resort Levy (**CSLR**) Bill 2021 and related bills.

Recommendations 3.9, 4.12, 6.6, 6.7 and 6.8 of the Financial Services Royal Commission recommended the extension of the Banking Executive Accountability Regime to all APRA-regulated entities, with joint administration from APRA and ASIC.

We note that the Government has released for consultation *the Financial Accountability Regime (**FAR**) draft Bill* (**Bill**) and introduced a revised Bill into Parliament in October 2021. The Government has also released exposure draft explanatory materials (**EM**), an information paper on joint administration (**Information Paper**), a policy paper on prescribed responsibilities and positions (**Policy Paper**), and a Questions and Answers document for consultation (**Q&A**).

While we acknowledge the intent of the Bill and understand the recommendation from the Financial Services Royal Commission to increase executive accountability in APRA-regulated entities, we have some general concerns as follows:

1. **Foreign entities within scope**: the extent to which the regime potentially applies to foreign entities should be limited. This includes connected entities of an RSE Licensee (not limited to subsidiaries, so may include upstream foreign entities beyond the immediate shareholder of the RSE Licensee), which in some group structures includes entities over which the accountable entity would not be able to exercise control.
2. **Accountable persons within scope**: many more persons in an entity will likely be characterised as accountable persons (**APs**) than was the case under the Banking Executive Accountability Regime (**BEAR**). The cost and benefit of such an extensive reach is questionable. The FAR should make it clear that foreign executives are not covered, unless they are holding a prescribed responsibility or position in relation to an Australian branch or other operations in Australia of an entity.
3. **Reasonable steps to comply with financial services laws**: the obligation for an accountable person to take reasonable steps in conducting its responsibilities to prevent matters from arising that would (or would be likely to) result in a material contravention by the accountable entity of specified financial services laws is in our view likely to be unduly onerous for a single person and the scope of the obligation should be curbed.
4. **Deferred remuneration obligations**: the FSC believes clarity is required regarding a potential mismatch regarding the commencement of FAR on the one hand, and CPS 511 on the other.
5. **Independent office of the superannuation trustee**: we note that many RSE Licensees are required to maintain an independent office of the superannuation trustee or

"designated business unit" (to intermediate with related-party service providers in order to avoid undue influence on the RSE Licensee) with its own executive staff that may report to the Board of the superannuation trustee rather than to the CEO or other senior executives of the broader organization. It is unclear to what extent FAR will apply to these executive staff.

6. **Potential impacts for third-party service providers:** the FSC seeks clarity on the intended scope to capture contractors and independent service providers who hold a position "relating to" the accountable entity. The impacts for third party arms-length service providers is uncertain.
7. **Unintended consequences for recruitment and retention**: the FSC is concerned the FAR may operate as a disincentive to recruitment and adversely impact on talent retention strategies in the financial services sector, including attracting and retaining foreign nationals. We are also concerned the FAR may negatively impact businesses in being able to offer competitive employment opportunities compared to organisations with a different level of governance and expectation outside the financial services industry. This may create issues in attracting and retaining the required and key talent and capability.
8. **Regulator approach:** the FSC would welcome early release of joint regulatory guidance from APRA and ASIC and the opportunity for industry to participate widely in testing of the relevant single portal.
9. **Complexity and double jeopardy**: the interaction of FAR with general law and statutory rules is not always clear and misconduct could result in liability under both FAR and existing regimes, particularly the design and distribution obligations (**DDO**), breach reporting and other civil penalty provisions. There are instances where the FAR regime overlaps existing regulatory regimes. This overlap would allow a regulator to arbitrage the different regimes and choose between the different regimes.

2.2. Recommendations

A summary of our key recommendations are as follows.

1 **Significant related entities**. We recommend that the definition of ''significant related entities of accountable entities that are Registrable Superannuation Entity (**RSE**) licensees' be supplemented to include a second limb stating 'what is not a significant related entity of accountable entities that are RSE licensees' and/or limit the definition of 'significant related entities of RSE licensees' to onshore entities with direct operational control of the RSE licensee. Without providing this clarification within the legislation, the Bill could raise significant uncertainty and/or unintended consequences for foreign entities connected to an RSE licensee.

2 **Enhanced notification threshold**. Regarding the enhanced notification threshold, we recommend that consideration should be given to providing for a "buffer" where an entity in a particular period exceeds a core compliance threshold and/or a grace period during which an entity can progress to the enhanced compliance entity level.

3 **Accountable persons**. FAR appears to have a potentially wide reach numerically in terms of persons capable of being characterised as APs by way of ministerial discretion. We recommend that instead it should be set out in the legislation, as was the case with BEAR.

4 **Foreign executives**. We recommend that, unless they are holding a prescribed responsibility or position in relation to an Australian branch or other operations in Australia of an entity, foreign executives would not be covered.

5 **Reasonable steps**. The FSC recommends that the legislation be clarified to provide that the reasonable steps obligation will be assessed in relation to an accountable person's position, the circumstances at the time, the person's prescribed responsibility and level of expertise.

6 **Deferred remuneration obligation**. The FSC recommends providing further clarity regarding a potential mismatch regarding the commencement of FAR on the one hand, and CPS 511 on the other in respect of deferred remuneration.

7 **Designated business unit**. FSC recommends that the legislation or Policy Paper makes it clear how the approach to APs will address the independent office of the superannuation trustee or "designated business unit" scenario and APRA's intentions for designated business units. This should follow in determinations by the Treasurer of designated roles and responsibilities.

8 **End-to-end product responsibility**. It is not clear how the end-to-end product responsibility obligation (as referred to in the proposed prescribed list of responsibilities and positions for all locally incorporated accountable entities other than authorised or registered non-operating holding companies) interacts with the recently introduced DDO regime. We note that a person holding end-to-end product responsibility for a product may be expected to cover functions and tasks performed not just by a myriad of teams within the entity, but potentially, also by shared group services. Given the complexity of the interaction of DDO and other various recent legislative items we would recommend clarification in this regard.

9 **Limiting impacts for third-party service providers:** the FSC recommends that the legislation or Policy Paper makes it clear the scope to capture contractors and independent service providers who hold a position "relating to" the accountable entity. This should follow in determinations by the Treasurer of designated roles and responsibilities.

10 **Regulator approach**. We would recommend that the single portal be tested with industry before it enters full operation and the FSC would also welcome early release of draft guidance so that timely discussion and feedback from members can be obtained.

11 **Complexity and double jeopardy**. The FSC recommends that the legislation should be aligned as much as possible, such that the breach reporting regime under FAR is not inconsistent with other legislation and that further guidance is provided on how these obligations will interact and the extent to which the rules will clarify any longer or shorter periods.

12 **Civil penalties**. The FSC recommends that an example of when a civil penalty would apply and how this would be administered by APRA and ASIC is included in

the EM. Ideally however, we would prefer to see the relevant principles to the extent possible, expressed in the Bill.

2.3. Background

Entities subject to the FAR

Uncertainty and/or unintended consequences for foreign entities

We note paragraph 1.33 of the EM provides that an accountable entity's significant related entity can include entities incorporated outside of Australia and that this approach recognises that financial services are often provided by large international corporate businesses and the activities of foreign entities can have a significant effect on the provision of services within Australia. While we acknowledge this to be true, we note that such foreign entities may not have direct operational control over the onshore accountable entity. In this instance, it is not clear within the draft Bill if the nexus of control or influence is sufficiently severed by an immediate parent company as 100% shareholder of the accountable entity. If not, where does it stop, given frequently complex global corporate structures? Diagram 1.2 in the EM does not directly assist with this issue.

This issue is of particular concern where foreign entities are connected to an RSE licensee. The EM currently provides guidance on significant related entities of RSE licensees and includes; subsidiaries of the licensee, other related bodies corporate of the licensee (such as parent and sibling entities) and entities with certain control relationships with the licensee (paragraph 1.41). The current definition of 'significant related entities of accountable entities that are RSE licensees' (section 12 (3)(b)), includes the requirement for the significant related entity's business or activities to have a material and substantial effect on the RSE licensee. The considerations for determining whether a body corporate has a 'material and substantial effect' on the RSE licensee include (amongst others) 'the nature and extent of any independency between the body corporate and the accountable entity' and 'any organisational, financial or administrative arrangements between the body corporate and the accountable entity' (section 12(4)(c) and (d)). This would appear to capture ultimate parent companies of RSE licensees (which may be foreign entities), as an ultimate parent would have material and substantial effect over the RSE licensee (for example, the ultimate parent has the ability to sell a subsidiary) but the ultimate parent has no direct operational control.

Given the regulatory requirements applying to RSE licensees which require a strong Australian based governance structure (for example, SPS 510), foreign connected entities (and their foreign executives) of an RSE licensee should not be caught as significant related entities and accountable persons, respectively.

in view of the above, we **recommend** the following options:

(a) broaden the definition of ''significant related entities of accountable entities that are RSE licensees' to include 'what is not a significant related entity of accountable entities that are RSE licensees'. For example, the definition could state that a body corporate is not a

significant related entity of an accountable entity that is a RSE licensee if the body corporate is a foreign entity; or the body corporate has no direct operational control over the RSE licensee. This approach of defining what is not considered a significant related entity of an accountable entity that is a RSE licensee would be consistent with what is provided for in the definition of 'significant related entities of accountable entities other than RSE licensees'; and/or

(b) limit the definition of 'significant related entities of RSE licensees' to onshore entities with direct operational control of the RSE licensee.

Without providing this clarification within the legislation, the Bill could raise significant uncertainty and/or unintended consequences for foreign entities connected to an RSE licensee.

Core compliance and enhanced compliance threshold

We note that under the FAR, in addition to the core notification obligations, accountable entities that meet the *enhanced notification threshold* are required to provide the regulator with an *accountability statement* for each of its accountable persons and an *accountability map*. According to the table in the Q&A, exceeding a stated level of total assets is the determinant of whether an entity meets the enhanced notification threshold.

We **recommend** that consideration should be given to providing for a "buffer" where an entity in a particular period exceeds a core compliance threshold and/or a grace period during which an entity can progress to the enhanced compliance entity level.

We also note that the Bill provides that Minister rules may set out how to determine when an accountable entity meets the enhanced notification threshold. The Minister rules may specify a method for working out the enhanced notification threshold and/or specify different methods for working out the enhanced notification threshold for different circumstances. We would appreciate early release of the draft rules to facilitate greater visibility on what is intended at this stage.

Accountable persons

Several points of concern arise as follows.

Ministerial discretion and wide scope of prescribed responsibilities and positions

We note also that FAR obligations and responsibilities are proposed to apply to a materially wider-ranging list of functions than is the case under the BEAR.

We note that the Policy Paper states that the Government will formally consult on the list of prescribed responsibilities and positions prior to the list being determined in the rules by the Minister. However, the Policy Paper also states:

"The full list of prescribed responsibilities and positions that would be set out in the rules determined by the Minister would comprise five sub-lists, namely the list of prescribed responsibilities and positions for:

- all locally incorporated ADIs, insurers, and registrable superannuation entity (RSE) licensees;
- all locally incorporated insurers (in addition to the first sub-list above);
- all locally incorporated RSE licensees (in addition to the first sub-list above);
- all Australian branches of foreign accountable entities; and
- all authorised/registered non-operating holding companies (NOHCs)."

FAR thus appears to have a potentially wide reach numerically in terms of persons capable of being characterised as APs by way of ministerial discretion. We **recommend** that instead it should be set out in the legislation, as was the case with BEAR.

The Policy Paper significantly expands the list of responsibilities to include executives who have specific responsibilities that do not give them management or control over the entity or the group (e.g. actuarial functions). This is not welcome and is likely to have an effect that is contrary to the legislative purpose of ensuring that key executives are accountable for key functions across a regulated group.

We also understand that in an ADI group structure, several of the prescribed responsibilities for RSE licensees and insurers (e.g. actuarial function, claims handling) may already be covered by the broad accountabilities of the accountable person responsible for the business unit within which the RSE licensees and insurers operate. We would welcome clarification that where an RSE licensee and/or insurer operates as a subsidiary of an ADI, the new prescribed responsibilities for RSE licensees and insurers should not apply to the extent that they are already covered in this way.

Inappropriate coverage of foreign executives

The FAR should make it clear that foreign executives are not covered, unless they are holding a prescribed responsibility or position in relation to an Australian branch or other operations in Australia of an entity. In this regard we also note that the concept of "branch" is not defined in the Bill and the concept should be clarified and supplemented to cover other operations in Australia that may not fall within the definition of a branch.

This issue is of some significance to certain groups of our membership. For example, some RSE licensees are subsidiaries of overseas entities (for which the definition of 'foreign accountable entity' does not apply (see Section 8 of the Bill)) and, given recent market changes, in the order of 80% of Australian life insurers are foreign owned.

We note that it is not uncommon for such Australian-based entities owned by global entities to have matrix reporting structures which could impact the prescribed positions, for example:

(a) (i) Australia-based executives report to an *offshore executive,* often with functional responsibilities within global operating models (for example, a global or regional head of IT) while sometimes (but not always) having a dotted reporting line to the local chief executive; or

(ii) Australia-based executives report to the local chief executive but have dotted reporting line to an *offshore executive*.

(b) Local chief executives often report to a *global or regional executive* (e.g. an Asia-Pacific).

We further note that Table 4 of the Policy Paper specifically includes:

- The senior executive responsible for the conduct of all the activities of an Australian branch of the foreign ADI, Category C insurer or Eligible Foreign Life Insurance Company (EFLIC); most likely the *Head of Branch or Country or similar*.
- *The Senior Officer Outside Australia* as defined under Prudential Standard CPS 510 Governance.
- *All members of the Compliance Committee* of an EFLIC as defined under Prudential Standard CPS 510 Governance.
- *Agent in Australia of a Category C insurer* as defined under Prudential Standard CPS 510 Governance.

In the circumstances we have outlined above, we **recommend** that, unless they are holding a prescribed responsibility or position in relation to an Australian branch or other operations in Australia of an entity, foreign executives would not be covered.

This is on the basis that

- these executives would be subject to regulation in a home jurisdiction and there are practical difficulties in seeking to apply the provisions of the FAR in the circumstances we have outlined; and
- there is direct operational and accountability and decision making at the Australian (onshore) entity level (for example, if there is an Australian-domiciled executive who could be assigned as an accountable person, a foreign executive should not be assigned as an accountable person).

The FSC also suggests that Section 11 of the draft Bill be broadened to provide for additional carve-outs to ensure there are no unintended consequences for foreign executives of RSE licensees of accountable entities or significant related entities in this regard.

Accountable person reasonable steps obligation

There is a new obligation imposed on APs by the Bill. An accountable person must take reasonable steps in conducting their responsibilities as an accountable person to prevent matters from arising that would (or would be likely to) result in a material contravention by

the accountable entity with any of the following that applies in relation to the accountable entity:

(i) this *Act*;
(ii) the *Banking Act 1959*;
(iii) the credit legislation (within the meaning of the *National Consumer Credit Protection Act 2009*);
(iv) the *Financial Sector (Collection of Data) Act 2001*;
(v) the financial services law (within the meaning of section 761A of the *Corporations Act 2001*);
(vi) the *Insurance Act 1973*;
(vii) the *Life Insurance Act 1995*;
(viii) the *Private Health Insurance (Prudential Supervision) Act 2015*;
(ix) the *Superannuation Industry (Supervision) Act 1993*;
(x) regulations, instruments, directions or orders, made under a law referred to in any of subparagraphs (i) to (ix)."

This is potentially an unduly onerous requirement, as it will require accountable persons to be able to demonstrate how they have exercised reasonable steps to ensure compliance with financial services laws. This could add a significant compliance burden to the existing compliance frameworks which already address the financial institution's compliance measures in respect of the financial services laws. We **recommend** that the legislation be clarified to provide that the reasonable steps will be assessed in relation to that person's position, the circumstances at the time, the person's prescribed responsibility and level of expertise.

In addition, the FSC believes that the risk of assessing "reasonable steps to prevent matters" with hindsight bias is material and it should be clarified that reasonable steps must be assessed from the perspective of the person taking those steps at the relevant time, not after the fact.

The FSC **recommends** that regulatory guidance or failing this relevant commentary in the EM should give added attention to this obligation. The use of relevant examples for members would be helpful to provide further clarity as to the intent.

Deferred remuneration obligations

The FSC believes there may be a mismatch regarding the commencement of FAR on the one hand, and CPS 511 on the other.

Initially both APRA and Treasury broadly had the same position on CPS 511 and FAR commencement dates as it relates to variable reward arrangements i.e. for a December year end company, where the commencement date occurs midway through the performance period (1 July 2023), variable reward arrangements could commence complying from the next performance period (1 January 2024); however, where a new employee joined after the

commencement date but before the next performance period, their arrangements would need to comply from their employment start date (i.e. not from 1 January 2024).

APRA then updated its position in its 18 October 2021 letter for CPS 511 and stated that employees who joined after the commencement date but before the next performance period (i.e. between 1 July 2023 - 31 December 2023), would be provided the same flexibility to have their variable reward arrangements comply from the next performance period (1 January 2024). While APRA has updated its position on this matter, it is yet to be seen if Treasury will take the same position for the variable reward arrangements of new Accountable Persons that join after the commencement date but before the next performance period.

The FSC would hope that they would become aligned given both Treasury and APRA are administering FAR. In the scenario that Treasury does not update its position, the implication for companies is that for Accountable Persons who join between 1 July 2023 - 31 December 2023, their variable reward arrangements will need to comply with FAR from their joining date and not 1 January 2024, although CPS 511 variable reward arrangements for all employees can still commence complying from 1 January 2024.

The impact of this misalignment is that potentially the FAR deferral conditions will need to apply for new executives who join from July 23. These are different deferral conditions to 511 that come in to play from January 2024."

The FSC **recommends** that clarification be provided on the above issue.

Independent Office of the Trustee

We note that many RSEs maintain an independent office of the superannuation trustee or "designated business unit" with its own executive staff who may report to the Board of the superannuation trustee rather than to the CEO or other senior executives of the broader organisation. Often, this has been required by APRA of RSEs. The superannuation trustee may also receive services from and/or be supported by executives of a related party or group entities. We also note that APRA recently has been requesting and intimating that all RSE licensees implement and maintain an independent office of the superannuation trustee or "designated business unit" with its own executive staff. In determining APs for such an RSE licensee, it is unclear how FAR will respond to that situation. It also seems to us to be an unusual and indeed odd outcome if executives of a related-party service provider, always acting on an arm's length basis in relation to the RSE with deliberate oversight and scrutiny by the designated business unit, could be captured as APs, where the very purpose of the designated business unit is to disrupt undue influence on trustee decision-making.

In addition, we note that the Policy Paper states that the extended list of prescribed responsibilities is not intended to capture middle or lower management who may only have day-to-day responsibility for certain parts or aspects of the accountable entity or its significant related entities. However, the personnel working in an independent office of the superannuation trustee or "designated business unit" may be middle or lower management,

yet often exercise significant influence or control (including over the flow of information informing trustee board decision-making).

The FSC **recommends** that the legislation or Policy Paper makes it clear how the approach to APs will address this scenario for those RSEs and APRA's intentions for designated business units. This should follow in determinations by the Treasurer of designated roles and responsibilities.

Difficulties with end-to-end product responsibility

The FSC submits that the concept of end-to-end product responsibility is impractical and often does not mesh with commercial reality. This item covers functions and tasks performed not just by a myriad of teams within the entity, but potentially, also by shared group services. Further, other prescribed responsibilities would appear to fall within the scope of end-to-end responsibility for product, such as dispute resolution, remediation and finance. It is unclear how these other responsibilities would interact with a broad view of a product responsibility.

The Policy Paper provides that where multiple accountable persons are registered to hold the end-to-end product responsibility "they will not be held jointly accountable to the extent that they are not holding that responsibility for the same product or service". The difficulty with this concept will likely give rise to definitional challenges around what constitutes "same product" and/or "same service" and artificial distinctions drawn by industry seeking to limit liability. We would suggest further clarity is provided on what would give rise to joint liability.

It is also not clear to us how this obligation interacts with the recently introduced DDO regime. Given the complexity of the interaction of DDO and other various recent legislative items we would **recommend** clarification in this regard.

The FSC notes that the Policy Paper also provides "at this stage, only very limited exclusion is proposed, e.g. road-side assistance services offered by some insurers". We would suggest that industry be given the opportunity to provide specific suggestions for additional exclusions.

Potential impacts for third-party service providers

A person cannot be an accountable person if they do not "hold a position in, or relating to, the accountable entity" with a relevant responsibility prescribed by the Minister. In theory, an accountable person could be a contractor or service provider, as discussed in paragraph 1.48 of the EM:

> ***1.48*** *Accountable persons with specified responsibilities will primarily be persons appointed or employed by an accountable entity or its significant related entity, but could also include contractors and independent service providers (such as a consultant in charge of human resources for an accountable entity). [Section 10(2) to (4) to the Financial Accountability Regime Bill 2021]*

The FSC seeks clarity on the intended scope to capture contractors and independent service providers who hold a position "relating to" the accountable entity. The impacts for third party arms-length service providers, such as administrators and asset managers, is currently unclear.

Regulator Approach

Preparations for implementation and registration

Prior to the implementation of the FAR, we note that the regulators are expected to release joint regulatory guidance to guide and assist accountable entities in the implementation and registration processes. Given the importance of this regulatory guidance to enable entities to prepare for FAR implementation, we would suggest that some clarity be given as to when this will be released, and whether there will be any consultation on this regulatory guidance.

In addition, the regulators expect to support implementation and registration through:

- establishing a single portal to receive applications for registration of accountable persons;
- establishing a single point of contact for accountable entities to raise any queries or requests they may have; and
- determining the appropriate form for registration.

We would **recommend** that the single portal be tested with industry before it enters full operation and the FSC would also welcome early sight of draft guidance so that timely discussion and feedback from members can be obtained.

Single portal and single point of contact

We note that the Information Paper states that information submitted by accountable entities through the single portal would be made available to APRA and ASIC for the purposes of administering the FAR and that entities are not expected to submit the same information to each regulator individually. We would suggest that the legislation includes an express provision stating that information provided through this portal is deemed to be submitted to both regulators.

Facilitating regulatory arbitrage

There are instances where the FAR regime overlaps existing regulatory regimes. For example, under the Superannuation Industry (Supervision) Act 1993 (**SIS** Act), the regulators have powers to:

- Conduct investigations;
- Conduct examinations;
- Request information;
- Issue directions;
- Request enforceable undertakings;
- Issue injunctions.

However, there are misalignments between the legislation. For example, APRA's directions power under the SIS Act permits APRA to give a direction where APRA "has a reason to believe" the RSE licensee has contravened a provision of the SIS Act. Under FAR, APRA may give a direction where it "has reasonable grounds to believe". The FAR wording imposes an objective test (which is arguably stricter) whereas the SIS Act test is subjective. The FSC suggests that other regimes be amended to ensure alignment with the FAR regime.

Otherwise, a regulator could arbitrage the different regimes and choose between the different regimes.

Notification obligations

Our understanding is that the FAR notification requirements coexist with existing breach reporting requirements. Thus there is a potential misalignment between an entity's existing reporting obligations and the FAR. Entities are obliged to report significant breaches of the Corporations Act to ASIC and to APRA under individual pieces of legislation depending on the entity. There is a 10-day time limit for reporting a significant breach. The FAR appears to require that **all** breaches of the obligations be reported, and the timeframe is 30 days, although the regulator can provide for a longer period than 30 days for compliance. The FSC **recommends** that the legislation should be aligned as much as possible, such that for example only 'significant breaches' are to be reported under the FAR.

The FSC **recommends** the issue of further guidance on how these obligations will interact and the extent to which the rules will clarify any longer or shorter periods.

Penalties

FAR will provide APRA and ASIC with the power to disqualify an accountable person if they fail to comply with their accountability obligations. These will be reviewable by the Administrative Appeals Tribunal, with questions of law being capable of appeal to the court. The concern here is that there are multiple avenues for various regulators to impose penalties, with different Acts containing similar prohibitions having different penalties, and a lack of clarity on how this would apply in the FAR regime. For example, the civil penalties that can be imposed on RSE licensees would differ depending on whether action is taken against them for breach of the standard of care in SIS, the efficiently, honestly and fairly obligation in the Corporations Act and the honesty, integrity and standard of care obligations in FAR. Finally, in this context, it is unclear whether ASIC and APRA can each seek civil penalties under the FAR regime, and we would submit it would be appropriate for one regulator to 'front run' pursuing a civil penalty on behalf of both regulators. The FSC **recommends** that an example of when a civil penalty would apply and how this would be administered by APRA and ASIC is included in the Explanatory Memorandum. Ideally however, we would prefer to see the relevant principles to the extent possible, expressed in the ED.

3. Part B – Compensation Scheme of Last Resort (CSLR)

3.1. Executive Summary

The FSC supports a strong and competitive financial services industry which provides consumer confidence and has the appropriate consumer protections. The establishment of the CSLR, through the Compensation Scheme of Last Resort Levy Bill 2021 and related bills (**Bills**), implements Recommendation 7.1 from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry Final Report (**Recommendation 7.1**).

The CSLR will provide compensation to consumers where the Australian Financial Complaints Authority (**AFCA**) has found that a financial product or service within the scope of the scheme is unable to pay the AFCA determination.

A targeted CSLR with Sector Specific Funding

Recommendation 7.1 supports the establishment of a CSLR that is consistent with, and also goes beyond, the Ramsay Review. The Ramsay Review made three recommendations on the establishment of a CSLR, including that the CSLR should be "limited and carefully targeted at the areas of the financial sector with the greatest evidence of need."[1] The Ramsay review also recommended that if a CSLR was established, it should initially be restricted to financial advice failures and the third Ramsey review recommendation related to design features of the scheme.

The greatest source of unpaid determinations have historically come from financial advice as noted in the Treasury CSLR Discussion Paper issued in 2019.[2]

The CSLR set out in the Bills establishes a scheme which covers personal financial advice and goes beyond the Ramsay recommendations by also covering credit activities and dealing in securities (other than issuing securities) for retail clients.

In relation to the scheme design, the FSC supports a targeted scheme which is funded by the sectors responsible for unpaid determinations via sector specific funding. This provides the greatest incentive for the relevant sector to raise standards and support reforms that reduce the risk of unpaid determinations arising from the sector.

While much of the funding detail for the CSLR will be set out in regulations, the design of the proposed CSLR envisages however that there is likely to be some general cross-subsidisation from initial funding, with funds raised from various sectors to be placed into a single pool to be

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[1] Recommendation 1 (2017) Page 13, Supplementary Final Report to the Review of the financial system external dispute resolution and complaints framework (treasury.gov.au)
[2] CSLR Treasury Discussion Paper 2019

used to fund claims, as well as a $5m capital reserve which is to be used to fund sector shortfalls.

Where additional levies are needed, the FSC submits they should be funded by the relevant sector as the starting position, and to the greatest extent possible overall. This is key to ensuring the CSLR is as equitable as possible, notwithstanding that the whole scheme has a premise that those who are well resourced and capitalised should fund the misdeeds of those who have been poorly or inadequately financially resourced.

Concurrent reform needed to address the source of unpaid advice determinations and reduce consumer harm with ASIC enforcing existing laws.

In addition to appropriate CSLR design measures, a commitment by the Government and ASIC is needed to strengthen advice licensee capital and insurance arrangements, including ASIC undertaking proactive oversight over appropriate financial arrangements that are already required in law. These measures will help to address the source of the problem and reduce the consumer risk of unpaid determinations.

We support the recently commenced Government review into professional indemnity insurance (**PI**) for the financial advice sector. In addition to the availability of appropriate PI, there must be proactive ASIC oversight to ensure that; advice licensees obtain suitable PI cover, covering all the products and services that a provider is licensed to give financial advice on and that the licensee has sufficient capital to meet excess payments should there be a claim against the PI policy. Without sufficient capital to pay the excess, the insurance cover will not respond. This can readily be undertaken by ASIC through regular risk based reviews of a representative sample of advice licensees, to encourage good practices regarding financial and PI requirements.

Without greater ASIC oversight over existing laws, the CSLR itself will do little to reduce the consumer risk of unpaid AFCA determinations and simply shifts the cost, via levies, to financial services companies that have done nothing wrong.

A well designed regulatory financial system, is one which reduces the risk that lead to unpaid determinations in the first place and not just one which places a safety net beneath it, in the form of a compensation scheme of last resort.

Whilst this submission makes a number of recommendations regarding the design of the CSLR, which needs to be sustainable and should be as equitable as is possible, the FSC considers that the CSLR Bills accurately balance the needs to protect the interests of consumers that have experience loss, consumers of financial products and the financial services industry.

3.2. Recommendations

To ensure that the CSLR is as sustainable and equitable as possible, the FSC supports the following measures:

1. The FSC supports a targeted CSLR which is funded by the sectors responsible for unpaid determinations via sector specific funding. The CSLR proposed in the Bills is consistent with, and also goes beyond, the Ramsay Review recommendations. The scheme will cover personal financial advice, which historically has been the largest source of unpaid determinations, as well as covering credit activities and dealing in securities (other than issuing securities) for retail clients.
2. Should additional levies be needed for the CSLR, it is recommended that they should be funded by the relevant sector as the starting position, and to the greatest extent possible overall.
3. ASIC should introduce minimum capital requirements for Advice Licensees – this can be phased in over a suitable transition period to help streamline any financial impact;
4. ASIC commences proactive oversight of Professional Indemnity Insurance (PI) and adequate financial arrangements held by Advice Licensees;
5. Supports provisions in the CSLR to prevent phoenixing - those responsible under the licence should also be prohibited from obtaining another AFSL where unpaid determinations have been paid by the CSLR;
6. The FSC supports the $150,000 cap on claims as proposed in the Bill which is key to supporting a sustainable CSLR;
7. There needs to be a further focus to reduce the administrative costs of the CSLR, which have been estimated to cost 46% of levies raised whilst only 54% of levies are estimated to pay out consumers for unpaid determinations; and
8. To align the CSLR cost recovery process with the annual ASIC levy in order to reduce the operational and administrative costs for providers required to fund the CSLR.

3.3. Background

Addressing the source of unpaid determinations whilst also providing a consumer safety net

The greatest source of unpaid determinations historically has been from financial advice, which is why the Ramsay Review recommended that a CSLR covering personal financial advice be established to begin with. The establishment of the CSLR will provide a safety net for consumers where the advice provider they are dealing with has been found to provide poor advice and does not have the financial capacity to pay compensation.

The funding of the consumer compensation will generally be sourced from other financial advisers who are well resourced and have not engaged in the misconduct – these costs will invariably end up being paid by other consumers through increased cost of services. This is

why it is critical that not only a sustainable and equitable CSLR is established, but that it is also supported by the right regulatory settings to prevent such losses in the first place.

The FSC continues to have concerns that the regulatory gaps, including the lack of oversight and enforcement by ASIC of existing laws, leads to unpaid determinations in the financial advice sector. This means that the source of unpaid determinations is not being addressed and the establishment of the CSLR will not change this.

The law already requires advice licensees to have adequate financial requirements and arrangements in place for compensating clients. There are however no minimum capital requirements for advice licensees. ASIC should also have regard to the PI claims experience to inform its view of adequate arrangements as exclusions and declinations mean the CSLR will be forced to prop up a PI framework that is not meeting requirements.

Whilst the updated 2020 ASIC Regulatory Guide 126 now specifies that in determining whether a licensee has appropriate financial arrangements in place, it should consider how it will cover the insurance excess, and keep records of this assessment,[3] we are not aware of ASIC providing proactive or regular industry oversight over these obligations. Further there should be a relationship between the capital a business holds and the level of PI excess chosen.

To ensure existing legal obligations are being met, ASIC needs to undertake regular risk based reviews of licensees (ensuring that they include a representative sample of advice licensees) focusing on licensees having adequate financial and compensation arrangements in place, which will serve two important purposes;

- it will identify those who have inadequate arrangements in place so that ASIC can take appropriate regulatory action and reduce the risk of consumer harm and unpaid determinations; and
- it will encourage licensees right across the industry to ensure they have the right arrangements in place.

We note that the Government has also commenced consultation on proposals to enhance the effectiveness of professional indemnity insurance in responding to compensation claims. We are supportive of this review. In addition to this, there needs to be greater ASIC oversight over whether advice licensees have obtained the right PI, and have sufficient financial arrangements to pay PI excesses in order to ensure that PI can respond to claims.

In this regard it is recommended that Advice Licensee arrangements are strengthened, together with greater ASIC oversight of financial and compensation arrangements, to reduce

[3] See page 14 of Regulatory Guide RG 126 Compensation and insurance arrangements for AFS licensees (asic.gov.au)

the risk of unpaid determinations and ensure the CSLR operates as a genuine last resort compensation scheme.

Sterling Income Trust

The collapse of the Sterling Income Trust and Sterling Group is currently the subject of a Senate Economics References Committee inquiry (**Sterling Inquiry**) which is due to report 1 February 2022.

The consumer losses arising from the collapse of the Sterling Group and Sterling Income Trust are extremely unfortunate, having created emotional and financial difficulty for many people.

When looking at such consumer losses, it is important to understand the cause of those losses and see what can be done to reduce the risk of this occurring in the future.

Nature of the Losses

ASIC's November 2021 submission to the Sterling Inquiry has identified that the losses were "primarily caused by product and organisational complexity, mis-priced products and a fall in the residential property market."[4] Many people were:

> *"sold a 'lease for life' where their long-term tenancy was linked to the performance of an investment. They were told that the returns from their initial lump sum payment would be sufficient to cover the rent on their long-term lease and that they would not be asked to make any other payments towards rent. This was both novel and high-risk…*
>
> *Ultimately the losses suffered by the tenant-investors were caused by exposure to a lease agreement that was dependent upon the financial success of the Sterling Group and the Sterling Income Trust, which both failed. While investigations are ongoing, and no criminal prosecution has to date been initiated, it is ASIC's view that certain aspects of the conduct involving the Sterling Group may have been criminal in nature and warrants close consideration by the CDPP."*[5]

The complexity with the Sterling collapse was exacerbated by the fact that those who entered into the lease for life were both tenants and investors. This resulted in two different regulatory bodies having jurisdiction over different components – ASIC is only empowered to deal with

[4] Page 3, ASIC Submission to the Senate Committee Inquiry into the Sterling Income Trust. 1. Submission Sterling - 8.11.21 ASIC.pdf
[5] Pages 3 and 4, ASIC Submission to the Senate Committee Inquiry into the Sterling Income Trust. 1. Submission Sterling - 8.11.21 ASIC.pdf

investors/the Sterling Income Trust whereas the lease arrangement was regulated by the Western Australian Department of Mines, Industry Regulation and Safety (**WA DMIRS**).

We note that public hearings are still underway and the Committee in the Sterling Income Inquiry will form its own view, based on the evidence received, whether ASIC acted accordingly to protect consumers in relation to the investment component of the collapse of the Sterling Group and Sterling Income Fund.

Regulatory regime to provide greater consumer protection - Design and Distribution Obligations

Two key reforms were not in place at the time the Sterling Income Trust was offered to consumers: the Design and Distribution Obligations (**DDO**), and the Product Intervention Powers (**PIP**).

ASIC has noted that if the DDO obligations had been in place when the Sterling Income Trust was offered, then the DDO:

> *"would have required the Sterling Income Trust to be marketed and sold in a way which was consistent with its target market. Under these obligations, the issuers and distributors of a 'novel' product (as well as 'non-novel' products) must have regard to the likely objectives, financial situation and needs of the consumers for which the product is intended and describe a target market for the product accordingly. If an appropriate target market cannot be identified for a product, the issuer will not be able to offer the 'novel' product."* [6]

Given ASIC's view that Stirling was "novel, complex and high-risk",[7] we consider that there is a high likelihood that the DDO would have gone a long way to protect consumers if it was in place at the relevant time. It would either not be able to be offered to the market if the provider could not identify a suitable target market, or alternatively it is likely that the product was only suitable for investment under restrictive conditions, particularly only being available to investors obtaining personal advice.

ASIC Chair Joe Longo, outlined in the Senate Committee hearings, that the returns sought for the investment were ambitious and between 10% and 15% in a near 0% interest rate environment. These returns were not achieved.

Making the reasonable assumption that the DDO would have prevented investment in the product without personal financial advice, this would have likely stopped vulnerable

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[6] Page 19, ASIC Submission to the Senate Committee Inquiry into the Sterling Income Trust. 1. Submission Sterling - 8.11.21 ASIC.pdf

[7] Page 6, ASIC Submission to the Senate Committee Inquiry into the Sterling Income Trust. 1. Submission Sterling - 8.11.21 ASIC.pdf

consumers from investing in such a product based on risk profile and product suitability where the adviser was acting in the best interests of the client.

ASIC's view was that had DDO requirements been in place at the time the Sterling Income Trust was offered, the RE would have been required to put in place controls and obligations which may have reduced consumer losses.[8]

ASIC also noted that if the Product Intervention Power was in place at the relevant time, ASIC may have used this power to reduce the risk of consumer harm by putting in place a product intervention order to temporarily prevent the inappropriate distribution of this product. ASIC also noted that there is a high threshold that needs to be met to enable ASIC to use this power, requiring it to establish a significant consumer detriment and ASIC having obtained sufficient evidence of this detriment to intervene.

While we acknowledge that ASIC has a finite set of resources, which means it cannot follow up every compliant received, we also note that ASIC having a power to take action is not sufficient to protect consumers if ASIC does not use the powers it has.

Having listened to some of the Sterling Income Trust Hearings, we question whether ASIC could have taken a more proactive approach to "actively obtain" sufficient evidence, rather than forming a view which may perhaps, at times, be overly reliant on evidence that ASIC receives from third parties.

Effective regulation and reducing consumer harm requires two key things – the right regulatory settings (such as PIP and DDO powers) and a regulator which uses the powers it has to enforce the law.

Given the above, the FSC considers that PIP and DDO, coupled with ASIC using these powers accordingly, would likely have resulted in large reductions in consumer losses had they been in force at the time the Sterling Income Trust was offered to investors.

Reducing the Risk of Phoenixing

The FSC is supportive of the requirement in the Bill for ASIC to cancel an AFSL operator's licence, as well as the ability for ASIC to make a banning order preventing persons or body corporates, for example, from holding an AFSL where that person is required to pay an amount in accordance with a relevant AFCA determination and the CSLR operator has paid that compensation in their place.

This is important to reduce the risk of phoenixing, where an operator abandons a company to avoid compensation and shifts the cost onto the CSLR, only to start a new company in the same sector.

Sustainable scheme caps and sector specific funding to the greatest extent possible

[8] Page 46, ASIC Submission to the Senate Committee Inquiry into the Sterling Income Trust. 1. Submission Sterling - 8.11.21 ASIC.pdf

The detail regarding CSLR funding is expected to be outlined in the regulations supporting the Bills. In this regard we note that the FSC supports sector specific funding to the greatest extent, whereby all those in the sector responsible for unpaid determinations pays for the respective losses/ CSLR costs. For example, all advisers contribute to CSLR advice related costs.

This approach provides the relevant sector, and firms within the sectors, with the interest and incentive to review regulatory settings and make changes to raise standards and reduce the risk of future claims within their relevant sector.

The CSLR as designed envisages that there will be a degree of cross-subsidisation with the $5m capital reserve raised as a single pool from all the sectors in the CSLR, as well as the ability to raise additional funds from sectors within the scheme and sectors outside of the scope of the CSLR, via Ministerial power, up to $250m in any given year.

Where additional levies need to be raised, the starting position should be that the CSLR raises additional levy from the sub-sector that the shortfall relates to and that gives rise to the need. For example, if unpaid determinations from the advice sector amount to $8m but only $6m has been raised. Additional levies of $2m should be raised from the advice sector.

To ensure the CSLR is sustainable, reasonable claims caps are needed, as well as an administratively efficient CSLR.

Sustainable claims caps

In this regard, the FSC supports the $150,000 cap on claims proposed in the Bill which is commensurate with the approach taken in the UK.

The $150,000 CSLR compensation limit represents 28% of the maximum that AFCA can award at $542,500. The UK Financial Services Compensation Scheme can award up to £85,000 to eligible persons which is 24% of the maximum award payable by the UK FOS at £350,000.

Setting an appropriate cap will help maintain competition in financial services sectors (by reducing the likelihood that CSLR costs act as barriers to entry or expansion) and will help to ensure viability of the scheme. It also recognises that the compensation being paid by the CSLR is funded by well resourced entities, who are not responsible for the misconduct or consumer losses.

Administratively efficient scheme

Under the levy framework, the CSLR operator determines, in a legislative instrument, the initial estimate of the claims, fees and costs for an upcoming levy period and a sub-sector. We note

that the Treasury Compensation Scheme of Last Resort: Proposal Paper issued in July 2021[9] estimated ongoing administrative costs for the scheme at $3.7m whilst estimating ongoing levies, without establishment and capital reserve costs, at $8.1m. This results in estimated administration costs representing 46% of levies raised, whilst only 54% of levies estimated to pay out to consumers for unpaid determinations.

The administration costs are disproportionately high compared to the actual purpose of the CSLR which is to make payment for unpaid determinations to consumers. Bearing in mind the purpose of the scheme, there needs to be a further focus, both at set up and annually thereafter, to keep CSLR administrative costs as low as is reasonably practical.

Furthermore, to minimise the industry's compliance costs associated with the CSLR, CSLR levies raised from the industry should be aligned with the annual ASIC levy process.

[9] Compensation Scheme of Last Resort - Proposal Paper (treasury.gov.au)