FSC FINANCIAL SERVICES COUNCIL

15 November 2024

Senate Standing Committees on Economics
PO Box 6100
Parliament House
Canberra ACT 2600

By email: economics.sen@aph.gov.au

Dear Secretariat

RE: Senate Economic References Committee Inquiry – wealth management companies

The Financial Services Council (**FSC**) welcomes the opportunity to make a submission to the Senate Economic References Committee (**Committee**) on potential improvements to Australia's regulatory framework for wealth management companies and the Compensation Scheme of Last Resort (**CSLR**).

The 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, financial advice licensees and investment platforms.

The financial services industry is responsible for investing more than $3 trillion on behalf of over 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 one of the largest pools of managed funds in the world.

As a peak body for both fund managers and financial advice businesses, the FSC is in a unique position to bring together the views of the industry on the current and future scope and operation of the CSLR.

In this submission, the FSC sets out the view that the CSLR is not sustainable in its present form. In particular, the FSC considers the CSLR has imposed unduly high levies on financial advisers due to:

- the retrospective application of legislation to Dixon Advisory cases;
- the scheme's high administrative costs; and
- a decision by Government not to fund the scheme's first year of operation (combined with a series of delays leading to slower than anticipated rollout).

The FSC recommends that the CSLR should be redesigned to promote its long-term sustainability.

The FSC would be happy to assist the Committee further. Please do not hesitate to contact Jack Morgan (Policy Director, Investments and Funds Management) or Julia Hukka (Policy Manager, Financial Advice and Platforms) on jmorgan@fsc.org.au or jhukka@fsc.org.au.

Sincerely,

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1. List of recommendations

The FSC proposes the following recommendations related to the CSLR and the prevention of the collapse of wealth management companies. These are explored in greater detail in the body of the submission.

1.1. Summary of recommendations for the reform of the CSLR

Recommendation #1: The FSC recommends that there be a more comprehensive Treasury review of the CSLR to consider scheme impact, sustainability, and consumer outcomes. It is recommended the review consider the following:

1. an analysis of what is contributing to unpaid determinations, including an analysis of underlying factors and risks giving rise to consumer claims and the inability for Financial Services Providers (FSPs) to meet their financial obligations as and when required;
2. whether regulatory strengthening is needed to reduce the risk of unpaid determinations in a given sector and make recommendations for proposed reform to address weaknesses and gaps (whether required in ASIC guidance or legislative change)
3. any new or proposed regulatory changes at the relevant time to ensure the CSLR reflects and complements regulatory reform and does not complicate or hinder measures being taken to strengthen the industry and reduce the rate of consumers seeking to rely on the CSLR;
4. an assessment of the impact of the scheme by;
    a) considering the economics and viability of funding the scheme (including analysis of current and potential future impact).
    b) considering the impact of the CSLR on competition and industry viability perspective; and
5. considering how the scheme is performing from a consumer outcome perspective.

Recommendation #2: The FSC supports scoping the CSLR to compensate victims for capital losses but not for unrealised, hypothetical capital gains. This would require AFCA to determine actual losses rather than applying “but for” compensation principles.

Recommendation #3: The FSC supports a comprehensive risk-based funding approach at an individual firm level being implemented by the Government as soon as reasonably practical. The CSLR should collect sufficiently detailed information about the profile of each firm and the reason for the unpaid determination to enable it to develop a more comprehensive risk-based funding approach in future.

Recommendation #4: The FSC supports introducing a per annum cap on the per capita amount that can be levied on financial advisers for the CSLR. This cap would provide

certainty and financial stability for advisers, ensuring they can continue to operate sustainably.

Recommendation #5: The FSC supports amending the CSLR framework to ensure that funds raised through levies are not directed towards paying for the CSLR operator's administrative expenses.

Recommendation #6: The FSC supports reducing CSLR operator costs by:

1. reducing the duplication of functions between AFCA and the CSLR operator; and
2. requiring the CSLR operator to focus on its core responsibilities to administer the CSLR without undertaking research, advocacy and policymaking activities.

Recommendation #7: The FSC supports a one-off injection of government funding to fund claims arising from the Dixon Advisory collapse.

Recommendation #8: The FSC recommends that, in addition to a one-off injection of government funding, the Minister stagger the CSLR levies or charge the levies by instalments to assist advice licensees in bearing the costs when there are large-scale incidents that are to be covered by the CSLR levies such as the Dixon Advisory claims.

Recommendation #9: The FSC recommends that, in the event that CSLR levies cannot be staggered for financial advice licensees, the Minister stagger the payment of individual compensation awards across multiple years to smooth the impact of one-off large-scale collapses of wealth management companies.

Recommendation #10: The FSC recommends the scheme operator should enforce subrogation rights to backdated claims. This includes the CSLR operator, or ASIC, using reasonable endeavours to pursue recovery under the financial services provider's professional indemnity insurance policy for the benefit of investors.

Recommendation #11: The FSC recommends the Government should consider strengthening the CSLR's subrogation rights, by imposing an obligation to use reasonable endeavors (i.e. not solely providing the CSLR operator a right) to pursue recovery. Consideration should also be given to imposing a legal requirement for financial services providers to provide a copy of their professional indemnity insurance policy to the scheme operator where the financial services providers have unpaid AFCA claims.

Recommendation #12: The FSC recommends the Committee investigate the possibility of increasing the priority given to the CSLR operator's creditor claims in liquidation or other means of streamlining subrogation rights to ensure the CSLR operator's claims are not prejudiced by statutory processes.

Recommendation #13: The FSC recommends ASIC ensure it is exercising its power under section 915H of the *Corporations Act* to require a licensee to hold PI insurance for the same length of time as ASIC requires the licensee to maintain AFCA membership after its license is cancelled.

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Recommendation #14: The FSC recommends ASIC should be exercising existing powers under s920A(1)(j) of the *Corporations Act* to ban a person linked to an AFSLs refusal or failure to pay AFCA determinations.

Recommendation #15: The FSC recommends the annual report published by the CSLR operator should include:

- information by entity name and also by subsector when outlining the number and value of payments of compensation made during the levy period;
- information about the size of the entity (e.g. sole operator) and the reason for the unpaid determination (e.g. insufficient capital to fund the excess under the PI policy), as opposed to information about the types of products and/or services covered by the relevant AFCA determinations;
- information on any monies the CSLR operator has recovered under the subrogation rights and any expenses associated with the recovery;
- in relation to any compensation claim paid by the CSLR operator, whether the operator exercised its right of subrogation and pursued compensation under a relevant professional indemnity policy and, if not, a clear explanation as to why it did not take these actions.
- a balance sheet for each sub-sector to show whether there are any reserves attributable for each sector at the end of each levy period.

See Section 3 for more detail.

1.2. Summary of recommendations for preventing/mitigating the collapse of wealth management companies

Recommendation #16: The FSC recommends Treasury explore the viability of professional indemnity and capital adequacy requirements for advice licensees to reduce the burden on the CSLR.

Recommendation #17: The FSC recommends ASIC review its AFSL and scheme registration processes, including the information it captures as part of an AFSL application and scheme registration forms/processes to capture enhanced data points that will lead to either a fast track or slow track registration processes depending on the particular MIS. These enhanced data points will inform risk-based surveillance processes at the outset, to be implemented following registration of a MIS.

See Section 4 for more details.

1.3. Related recommendations

Recommendation #18: The FSC recommends the Government should adjust penalty structures to promote the de-risking of the financial advice sector.

Recommendation #19: The FSC supports improving decision-making by AFCA to ensure CSLR payments occur in a consistent, transparent and accountable manner, and making

assessments more rigorous through the involvement of a contradictor to scrutinise compensation claims.

Recommendation #20: The FSC recommends clarifying the application of special levies in circumstances where FSPs have divested themselves of leviable entities.

See Section 5 for more details.

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2. Background

2.1. The collapse of Dixon Advisory

Dixon Advisory & Superannuation Services Pty Ltd (Dixon) entered voluntary administration in January 2022 after directors determined that the liabilities from class actions, settlements and regulatory penalties would cause Dixon to become insolvent.[1] The company was accused of offering poor advice, particularly around investing in related-entity products. These investment recommendations caused many clients to suffer financial losses and led to over 2,773 complaints against Dixon being made to the Australian Financial Complaints Authority (AFCA) as at 30 June 2024.[2]

Key contributors to the collapse of Dixon included:

- **Conflicted Advice:** Dixon's financial advisers heavily promoted related entity's investment products, in a way which raised legitimate questions about whose interests were being prioritised. By way of example, many Dixon clients were advised to make excessive asset allocations to the New York and New Jersey property market through Dixon's US Masters Residential Property Fund equities and/or convertible preference units (URF), as well as to invest in other financial products from Dixon's related parties.[3] The URF was erroneously described by advisers as having "both defensive and growth" characteristics, yet AFCA later determined it was clearly a high-risk investment that should have been considered "growth".[4] These asset allocations have not been rationally explained except by reference to the close relationship between Dixon and the related parties. It appears Dixon may have advised its clients to invest in its own related-party products. When the URF declined in value, this impacted Dixon clients who had been advised to invest in the units, preference shares and bonds of the URF.[5]

- **Breach of Fiduciary Duties:** Financial advisers are legally bound to act in their clients' best interests according to section 961B of the *Corporations Act 2001* (Cth) (Corporations Act) which imposes obligations on financial services licensees to ensure the advice provided is appropriate. Dixon, however, was penalised by the Federal Court for having breached the best interests duty and failed to provide appropriate advice to its clients.[6]

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[1] Jonathan Shapiro and Carrie LaFrenz, Dixon Advisory files for voluntary administration as claims mount, *Australian Financial Review*, 19 January 2022.
[2] Australian Financial Complaints Authority, Dixon Advisory and Superannuation Services Pty Ltd (Subject to Deed of Company Arrangement), September 2024.
[3] Australian Financial Complaints Authority, Determination, Case Number: 716627, 6 February 2024, p.1.
[4] Australian Financial Complaints Authority, Determination, Case Number: 716627, 6 February 2024, p.4.
[5] Jonathan Shapiro and Carrie LaFrenz, Dixon Advisory's troubled US property fund assets to be sold, *Australian Financial Review*, 28 March 2022.
[6] Australian Securities and Investment Commission, Dixon Advisory penalised $7.2 million for breaches of best interest obligations, 19 September 2022.

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- **Incorrect description of the risk of asset categories:** AFCA determinations found that Dixon repeatedly misclassified the URF as a "mixed" asset with defensive and growth characteristics.[7] This classification misled clients, as it suggested a level of diversification and risk mitigation that was not present. In reality, AFCA determined that the URF should have been described as part of the growth component of clients' SMSF portfolio.[8]

- **Failure of Risk Management:** Dixon was accused of failing to manage risk adequately, especially in relation to its clients' superannuation funds. Clients were exposed to high-risk, illiquid investments, such as the URF, which were not always suitable for their financial goals and risk tolerance.

- **Failure of Regulatory Enforcement:** According to the FAAA, there were early warnings and red flags about Dixon's practices as early as 2008,[9] however ASIC did not commence civil penalty proceedings against the firm until September 2020.[10] ASIC confirmed at the Senate Estimates hearing on 4 June 2024 that they were investigating Dixon between 2015 and 2019, however ultimately decided not to take any action against the financial advisers.[11] This delay in response allowed the firm to continue operating despite questionable practices that caused significant financial harm to investors.

By 30 June 2024, AFCA had registered a total of over 2,773 complaints against Dixon.[12] According to the Compensation Scheme of Last Resort Limited operator's (CSLR operator) actuaries, in FY24 Dixon complaints represented around 81% of the anticipated costs associated with CSLR claims.[13]

2.2. The creation of the Compensation Scheme of Last Resort

The CSLR operator is a not-for-profit corporation founded to compensate retail consumers for financial misconduct after they have exhausted all other compensation avenues. The CSLR was created in response to a recommendation from the government-commissioned Ramsay Review (2017) and findings from the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry that many consumers, despite being owed compensation, were left without recourse when wealth management companies became insolvent or unable to pay.

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[7] Australian Financial Complaints Authority, AFCA determinations public reporting, Determination case number: 12-00-783974, 30 July 2024.
[8] Australian Financial Complaints Authority, AFCA determinations public reporting, Determination case number: 12-00-783974, 30 July 2024.
[9] Keith Ford, FAAA pushes federal MPs on 'critical' Dixon public inquiry, *Independent Financial Adviser*, 12 September 2024.
[10] Australian Securities and Investment Commission, ASIC and Dixon Advisory enter conditional agreement to resolve ASIC civil penalty action, 9 July 2021.
[11] Commonwealth of Australia, Proof Committee Hansard: Senate Economics Legislation Committee Estimates, 4 June 2024, p.19.
[12] Australian Financial Complaints Authority, Dixon Advisory and Superannuation Services Pty Ltd (Subject to Deed of Company Arrangement), September 2024.
[13] Finity, CSLR paper, 1st & 2nd Levy Period Initial Estimates (March 2024), March 2024, p.41.

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There were multiple attempts to establish the CSLR. The first CSLR bills were initially introduced to Parliament by the former Government in October 2021 then lapsed at dissolution in 2022. The second CSLR bills were introduced by the current Government in September 2022 but were discharged from the notice paper to be replaced by the third and final bills.[14] The third CSLR bills were introduced to Parliament in March 2023 and passed on 22 June 2023. The CSLR was designed to be jointly funded in its first year by the Government and through a levy on the 10 largest banking and general/life insurance groups and subsequently funded on an ongoing basis through a new annual levy on four sub-sectors: financial advisers, credit providers, credit intermediaries and securities dealers.[15]

The way the CSLR levy is calculated and imposed is as follows:

1. The CSLR engages an independent actuarial consultancy as Principal Actuary.
2. The Principal Actuary recommends an estimate of costs by conducting detailed modelling and analysis and following legislative and regulatory compliance.
3. A second independent Reviewing Actuary reviews the estimate determined by the Principal Actuary as a quality assurance mechanism.
4. The Principal Actuary produces an independent report for each estimate, which the CSLR publishes.
5. The levy instrument and explanatory memorandum are registered on the Federal Register of Legislation managed by the Office of Parliamentary Counsel.
6. The instrument is tabled in each House of Parliament.
7. ASIC determines the levy portion for each financial firm. The levy is based on subsector caps and the firm's size.[16]
8. ASIC issues individual invoices to each firm.

The levy on each of these four sub-sectors is individually capped at $20 million per financial year and total overall levies cannot exceed a combined $250 million. The Minister for Financial Services (Minister) can vary the annual levies (up to the $20 million subsector cap) or impose an additional special levy up to the total combined cap of $250 million.[17] Special levies may be imposed on a range of subsectors, including those not subject to annual levies.

The CSLR can award a maximum of $150,000 for claims from retail consumers related to personal financial advice, credit provision, credit intermediation, or securities dealing.[18]

Before a claim can be lodged, a consumer must have an unpaid determination from AFCA.[19]

[14] Parliament of Australia, Treasury Laws Amendment (Financial Services Compensation Scheme of Last Resort) Bill 2023 [and associated Bills], 2023.
[15] Parliament of Australia, Explanatory Memorandum, Treasury Laws Amendment (Financial Services Compensation Scheme Of Last Resort) Bill 2023; Financial Services Compensation Scheme Of Last Resort Levy Bill 2023; and Financial Services Compensation Scheme Of Last Resort Levy (Collection) Bill 2023, 8 March 2023, p.15.
[16] Compensation Scheme of Last Resort, How we're funded.
[17] Parliament of Australia, Treasury Laws Amendment (Financial Services Compensation Scheme of Last Resort) Bill 2023 [and associated Bills], 2023.
[18] Ibid.
[19] Ibid.

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As set out in the Explanatory Memorandum, Division 2 of Part 7.10B of the *Corporations Act* provides that:

> *"The CSLR operator cannot consider the merits or facts of a dispute between a consumer and an AFCA member underpinning a relevant AFCA determination. Rather, the CSLR operator must make a compensation payment to a consumer if:*
>
> - *a relevant AFCA determination has been made in favour of the consumer;*
> - *the consumer is eligible for compensation;*
> - *the consumer makes an application for compensation under the CSLR; and*
> - *the consumer accepts the CSLR operator's offer of compensation."*[20]

2.3. The rollout of the CSLR and its application to Dixon cases

The issue of retrospective legislation

Dixon entered voluntary administration in January 2022,[21] the CSLR was not legislated until 22 June 2023 and it did not become operational until 2 April 2024. Nonetheless, the CSLR has been designed in such a way that has made financial advice licensees liable to compensate former Dixon clients, whose losses were mostly incurred well before 2022. The significant decline in financial advisers over the last 8 years from 27,953 advisers in 2018 to 15,589 in 2024 has also exacerbated the issue as the financial burden is spread across fewer advisers.[22]

This development has raised legitimate concerns: Dixon clients are receiving compensation from an industry-funded scheme which did not exist at the time the conduct in question occurred and was perpetrated by an entity which never paid CSLR levies. Instead, the scheme penalises current advice licensees for the historical misconduct of others.

Consequently, the financial advice industry is now left facing significantly higher ongoing levies contributing to the already growing costs of providing financial advice.[23] These higher costs are ultimately shouldered by consumers: either in the form of paying higher fees or being squeezed out of the market entirely.

Regulatory failures

Steep CSLR levies on financial advisers are not only a result of poor timing, but also a failure of regulatory deterrence and by ASIC for failing to intervene earlier. Dixon's conflicted advice

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[20] Parliament of Australia, Explanatory Memorandum, Treasury Laws Amendment (Financial Services Compensation Scheme Of Last Resort) Bill 2023; Financial Services Compensation Scheme Of Last Resort Levy Bill 2023; and Financial Services Compensation Scheme Of Last Resort Levy (Collection) Bill 2023, 8 March 2023, p.15.

[21] Jonathan Shapiro and Carrie LaFrenz, Dixon Advisory files for voluntary administration as claims mount, *Australian Financial Review*, 19 January 2022.

[22] Adviser Ratings, Australian Financial Advice Landscape, 2024, p.26

[23] John Collett, Consumers locked out of financial advice as fees keep rising, *Sydney Morning Herald*, 24 June 2024; *The Australian*, Compensation scheme of last resort has only just started and advisers are bracing for $135m bill, 19 July 2024.

structure was difficult to reconcile with the best interests duty which was mandatory from 1 July 2013.

While regulators have limited budgets and must make difficult choices with the resources available to them, it is important to note that earlier regulatory action could have mitigated the Dixon collapse. Moreover, since financial advice licensees paid (and continue to pay) levies to support ASIC's regulation of their industry, there is not a clear rationale for requiring licensees to pay higher CSLR levies to address claims arising from these systemic failures.

High administration costs

Costs associated with administering the CSLR are significantly exceeding initial Treasury estimates:

	Treasury's July 2021 estimate[24]	**CSLR's actuarial estimates for FY25[25]**	**Difference**
Total administrative costs	$3.7 million	$6.4 million	Up 73%
Total levies	$8.1 million	$24.1 million	Up 200%

There is a clear need to review the operational model of the CSLR and its scope as administration costs are unacceptably high. Nearly 27% of total levies in FY25 are being allocated toward scheme administration, which reduces the funds available to compensate consumers or reduce total levies.[26] There needs to be a greater focus on keeping administrative costs as low as is reasonably practical as it is unacceptable for administrative costs to represent such a high proportion of the CSLR's expenditure.

2.4. The proposed expansion of the CSLR

The CSLR was initially proposed by the government-commissioned Ramsay Review (2017) to provide redress in situations where consumers suffer financial loss due to unpaid compensation arising from financial advice failures. The Ramsay Review recommended that the CSLR should be targeted and limited to areas of the financial sector with the greatest evidence of need, and that its primary scope should be financial advice failures.[27] The rationale behind this limitation was to ensure the CSLR remains efficient, manageable, and true to its core purpose of addressing specific systemic gaps, without overextending its coverage.

Design Intent of the CSLR

[24] The Treasury, Compensation Scheme of Last Resort - Proposal Paper (treasury.gov.au), pp.17,19.
[25] Finity, CSLR paper, 1st & 2nd Levy Period Initial Estimates, March 2024, pp.46 and 56.
[26] Finity, CSLR paper, 1st & 2nd Levy Period Initial Estimates, March 2024, pp.46 and 56.
[27] Commonwealth of Australia, Supplementary Final Report: Review of the financial system external dispute resolution and complaints framework, 2017, p.58.

The Ramsay Review emphasised that the CSLR should not be a broad safety net for all financial sector failures but should instead be scalable to cover other financial services only if evidence arises showing substantial problems with unpaid compensation in other areas.[28] By focusing on financial advice failures, the CSLR addresses a well-documented area where consumers have been left vulnerable due to the collapse of advice firms and unpaid determinations from AFCA.

The CSLR's design also hinges on the principle that strong regulatory settings must exist to ensure financial firms are accountable and capable of compensating consumers in the first place. Expanding the scheme too widely could detract from the regulatory focus needed to ensure firms are held responsible for their own failures.

Risks of Expanding the CSLR

The proposition to expand the CSLR poses a number of systemic risks, including:

- **Dilution of Focus:** Expanding the CSLR risks diluting its original purpose and effectiveness. The scheme was designed to fill a gap where there was clear evidence of firms being unable to meet compensation obligations, primarily in the financial advice sector.
- **Increased Financial Burden:** Broadening the scope of the CSLR would significantly increase the financial burden on the entire financial services industry, including compliant advisers and licensees.
- **Moral Hazard:** Expanding the CSLR could inadvertently encourage a greater moral hazard, where clients, licensees or others captured by the scheme become less cautious, knowing that any financial shortfall will be covered by the CSLR, or regulators become less motivated to undertake enforcement activities against bad actors to recover lost funds. This would undermine the regulatory objectives of ensuring firms are held accountable for the financial risks they assume. A broader CSLR might also weaken market discipline by reducing incentives for consumers to exercise caution when making financial decisions.

Risks associated with the incorporation of AFCA complaints concerning MISs into the CSLR

Some industry participants have raised questions about whether the collapse of Dixon was primarily an issue with financial advisers breaching the best interests duty or a product issue with the URF, and used this to advocate incorporating managed investment schemes (MISs) into the CSLR. The incorporation of AFCA complaints concerning MISs would significantly expand the CSLR and potentially increase the cost burden on financial advisers. The FSC proposes that there are more appropriate mechanisms that could reduce the cost burden, which are explored in Section 3. If complaints against MISs were to be brought within the scope of the CSLR, it is not immediately clear that basis for it not also being expanded to capture other subsectors such as banking, superannuation or insurance.

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[28] Commonwealth of Australia, Supplementary Final Report: Review of the financial system external dispute resolution and complaints framework, 2017, p.60.

It is important to note that the Federal Court has accepted Dixon engaged in breaches of the best interests duty (section 961B of the *Corporations Act*) and appropriate advice duty (section 961G of the *Corporations Act*),[29] but has made no adverse findings against Dixon associated with the design of the URF as an MIS. The Court simply accepted that the URF products were "*highly risky*", which was why the Court considered the Dixon advisers' financial advice to so clearly breach sections 961B and 961G.[30]

There are a number of reasons why it would be inappropriate to incorporate MISs into the CSLR. These include:

- **Government underwriting investment risk:** Investment inherently involves risk, and losses in these schemes are typically linked to market performance or the underlying asset values. Unlike financial advice failures, losses in MISs may not stem from misconduct or negligence. Including them in a CSLR might create an inappropriate expectation for compensation where the loss is market-driven rather than a failure of regulatory obligations or advice standards. If the objective of the CSLR is to protect consumers from all downside risk and financial loss, additional subsectors such as banking, superannuation and life and general insurance companies could arguably be captured, which would be problematic for the general financial services industry. AFCA compensation is currently determined on the basis of "but for" principles; i.e if a bad investment was made on advice that contravened financial advice regulation, the compensation is made on the basis of the earnings which would have been made from investing in an average market product. Therefore, the determinations are linked to the inappropriateness of the advice rather than the product failure.
- **Costs passed on to consumers:** Higher regulatory costs are frequently transferred to consumers through increased fees. If the CSLR levy is applied to MISs in addition to financial advisers, there is a risk of double-charging consumers. This would happen if a client invests in an MIS and simultaneously receives advice from a financial adviser, as both the MIS and the advice service could pass on their respective CSLR-related costs to the consumer.
- **Design and Distribution (DDO) obligations:** DDO obligations commenced in October 2021. Under Part 7.8A of the *Corporations Act*, issuers and distributors of financial products must comply with design and distribution obligations which aim to ensure that products are being designed and distributed to their target market, reducing the risk of consumer detriment as high-risk MISs should not typically be offered to retail investors.
- **Product intervention powers:** Under Part 7.9A of the *Corporations Act* and Part 6-7A of the *National Consumer Credit Protection Act 2009*, ASIC has a product intervention power which enables them to intervene and when necessary, ban financial products and credit products when there is a risk of significant consumer

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[29] Federal Court of Australia, Australian Securities and Investments Commission v Dixon Advisory & Superannuation Services Ltd [2022] FCA 1105, 19 September 2022.
[30] Federal Court of Australia, Australian Securities and Investments Commission v Dixon Advisory & Superannuation Services Ltd [2022] FCA 1105, 19 September 2022.

detriment (see ASIC Regulatory Guide RG 272).[31] Therefore ASIC's intervention can limit MIS failures before they occur, reducing their risk of failure and the need for CSLR coverage. Furthermore, there is a moral hazard risk that including MISs within the scope of the CSLR might discourage ASIC from the proactive use of its product intervention powers to protect consumers.

The inclusion of MISs in the scheme was considered early on in its creation but ultimately rejected in favour of a review of the MIS regulatory framework which commenced in 2023.[32] In a government document outlining Q&As around the CSLR, they acknowledged evidence of unpaid AFCA determinations relating to managed investment schemes, but considered that they were *"unsuitable for inclusion at this time"* and that *"the scope of the CSLR reflects financial products that have undergone significant regulatory reform which have reduced the risk of misconduct and failure. Managed investment schemes can involve high risk investments."*[33]

[31] Australian Securities and Investment Commission, Regulatory Guide 272: Product Intervention Power, June 2020.
[32] Treasury, Review of the regulatory framework for managed investment schemes, 2023.
[33] Treasury, Q&A: Compensation Scheme of Last Resort, p.4.

3. Recommendations for the reform of the CSLR

The CSLR was created to implement recommendation 7.1 of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. The rationale behind this recommendation was to foster accountability in the sector and to provide only a genuine last resort pathway to compensation. It is important for any reforms to the CSLR to be aligned with these objectives.

While the CSLR levies are directly paid by scheme members, ultimately they are paid for using funds raised from consumers. Given the consumer cost implications arising from a CSLR, it is important to ensure that CSLR payments are proportionate to losses and that the scheme is sustainable not only in the ordinary or average claim years but also in the years where there are large, unexpected losses. The CSLR should also remain truly last resort and the regulatory weaknesses in the advice licensing regime should be addressed to reduce the risk of future unpaid determinations arising from financial advice.

Recommendation #1: The FSC recommends that there be a more comprehensive Treasury review of the CSLR to consider scheme impact, sustainability, and consumer outcomes. It is recommended the review consider the following:

1. an analysis of what is contributing to unpaid determinations, including an analysis of underlying factors and risks giving rise to consumer claims and the inability for Financial Services Providers (FSPs) to meet their financial obligations as and when required;

2. whether regulatory strengthening is needed to reduce the risk of unpaid determinations in a given sector and make recommendations for proposed reform to address weaknesses and gaps (whether required in ASIC guidance or legislative change);

3. any new or proposed regulatory changes at the relevant time to ensure the CSLR reflects and complements regulatory reform and does not complicate or hinder measures being taken to strengthen the industry and reduce the rate of consumers seeking to rely on the CSLR;

4. an assessment of the impact of the scheme by;

    a) considering the economics and viability of funding the scheme (including analysis of current and potential future impact).

    b) considering the impact of the CSLR on competition and industry viability perspective; and

5. considering how the scheme is performing from a consumer outcome perspective.

The FSC notes that the present inquiry by the Senate Economic References Committee is focused on the collapse of wealth management companies – especially Dixon – and their implications for the CSLR. To meaningfully reform the CSLR, it must first be assessed more holistically, having regard to factors such as:

- The systemic operation of the CSLR, including situations where a wealth management company has not collapsed;
- How the CSLR is administered;
- The costs associated with administering the CSLR;
- The role of AFCA in facilitating CSLR administration;
- The compensation methodologies applied by AFCA;
- Possible duplication between the roles of AFCA and the CSLR;
- The success of the CSLR in exercising its subrogation rights;
- ASIC's role in encouraging scheme participants to comply with their obligations;
- Means by which the CSLR might be reformed to lower moral hazard risks;
- The economics and viability of scheme funding;
- The impact of the CSLR on competition and industry viability.

In the absence of more broad-based terms of reference, the FSC fears the present inquiry will be a missed opportunity for the Committee and will only provide Committee members with an unduly narrow insight into the CSLR.

Recommendation #2: The FSC supports scoping the CSLR to compensate victims for capital losses but not for unrealised, hypothetical capital gains. This would require AFCA to determine actual losses rather than applying "but for" compensation principles.

Currently AFCA determines compensation using "but for" compensation principles. Under this methodology, AFCA assesses what a client's portfolio might have looked like if unsuitable advice or other misconduct had not occurred. This approach results in CSLR compensation for hypothetical, unrealised gains rather than directly addressing direct capital losses. The CEO of the CSLR operator has publicly stated that 80% of the compensations that have occurred under the CSLR were for unrealised capital gains, and 20% were for capital losses.[34] Going beyond compensating consumers for their actual losses and instead compensating them for hypothetical missed gains undermines the purpose of the CSLR to truly be a scheme of last resort.

The FSC recommends that in making its determinations, AFCA both:

[34] Independent Financial Adviser, CSLR uncovered: Adviser impacts and the path forward, Webcast, 32:30min, https://www.ifa.com.au/webcasts/34843-cslr-uncovered-adviser-impacts-and-the-path-forward

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- continue to seek compensation from the liable party according to the “but for” principle; and
- calculate the actual financial loss (the difference between the amount invested and the capital value post-advice or misconduct, rather than theoretical portfolio gains), which is the sum that should be paid by the CSLR if the liable party fails to comply with its obligations.

Such an arrangement makes the CSLR truly last resort scheme. It would also provide a more consistent, transparent approach to awarding compensation under the CSLR, reduce costs, and ultimately ensure that compensation is directed toward clients who have suffered verifiable financial harm.

Recommendation #3: The FSC supports a comprehensive risk-based funding approach at an individual firm level being implemented by the Government as soon as reasonably practical. The CSLR should collect sufficiently detailed information about the profile of each firm and the reason for the unpaid determination to enable it to develop a more comprehensive risk-based funding approach in future.

The FSC considers that a robust and well-considered risk-based funding model, including detailed risk assessment at the individual firm level, should be the preferred approach for funding the CSLR. The FSC notes, however, that establishing a risk-based model at the individual firm level may have its challenges due to a shortage of suitable data. That said, the FSC submits that moving to a risk-based model at the firm level should be seriously considered and planned for by collecting and analysing suitable, available data.

If there is not a longer-term move to risk-based funding at the firm level, then the CSLR costs will continue to be disproportionately imposed on low-risk FSPs while higher-risk FSPs will avoid paying the costs they impose on the scheme. If low-risk FSPs are required to continually fund the failings of higher-risk FSPs, low risk FSPs will likely need to unduly increase their service costs to their customers. This in turn could result in consumers moving towards higher-risk FSPs, which will further increase the costs of the CSLR and exacerbate the moral hazard problems inherent in the CSLR.

For the CSLR to move towards a risk-based funding model, sufficient relevant data on the types of FSPs and the reasons for unpaid determinations should be collected, and the Government and CSLR using the data should develop a risk profile of FSPs to establish a more comprehensive risk-based funding model. Specific risk considerations could include the proportion of SMSF clients in an FSP’s portfolio and the proportion of in-house product recommendations they make.

The CSLR should collect and analyse data to determine the best and most efficient way to move towards a funding model based on risks at the individual firm level.

Initially, risk should be assessed based on data available from historical unpaid determinations for the financial services class level.

In assessing sector-based risk, the implicit presumption has been, for example, that all financial advice licensees have similar risk of calling on the CSLR, similarly for financial advice and other sectors covered by the CSLR. However, it is arguable that some licensees are more likely to generate claims than others and certain types of advice are more likely to generate claims. Therefore, there should be consideration of the value of assessing sector-based risk at a more finely grained level.

Recommendation #4: The FSC supports introducing a per annum cap on the per capita amount that can be levied on financial advisers for the CSLR. This cap would provide certainty and financial stability for advisers, ensuring they can continue to operate sustainably.

The FSC notes recent precipitous falls in financial adviser numbers and growing financial imposts from Government on licensees, advisers and their clients. On balance, the FSC considers a per capita limit on annual CSLR levies is appropriate until a risk-based funding model at the individual FSP level can be adopted. The FSC would be eager to work with Treasury on how a per capita limit may operate. This is an equitable and proportionate approach for the cap that would not unfairly advantage small or large businesses. Since the CSLR is imposed on the basis of the number of individual financial advisers employed by a licensee, the FSC sees such as cap as a simple way to ensure financial advice remains affordable.

There are clear advantages in imposing such a cap as they will limit the scheme's costs and encourage the CSLR operator to function efficiently. These ensure the scheme is sustainable, the industry remains competitive, and business has some degree of certainty. Limiting scheme costs would also help reduce the risk of high CSLR levies causing business failures, which would further exacerbate reliance on the CSLR (because a firm that fails due to the CSLR costs could in turn cause additional consumers seeking compensation via CSLR claims) and potentially cause a contagion effect.

The FSC also acknowledges an alternative policy proposal by the Opposition to reduce the sub-sector cap to $10m as it was originally proposed in their CSLR bills. This would likely have a similar effect to our proposal in reducing the cost burden on financial advisers and therefore financial advice. However, this would need to be combined with additional measures to bring the CSLR onto a more sustainable footing (for example, rationalising administration).

The FSC therefore considers, on balance, that a per capita-level cap should be implemented initially, at least until a risk-based funding model at the individual FSP level can be adopted.

Recommendation #5: The FSC supports amending the CSLR framework to ensure that funds raised through levies are not directed towards paying for the CSLR operator's administrative expenses.

As set out in Section 2.3 above, the CSLR's official estimates for FY25 total administrative costs exceed Treasury's July 2021 estimate by 73%, while the levies are 200% higher than estimated.[35] The FSC considers the primary focus of the scheme should be on compensating consumers and any leftover funds should be returned to scheme participants in the form of reduced levies in subsequent levy periods.

The FSC considers that the planned allocation of nearly 27% of total FY25 levies to scheme administration to be unduly high, having regard to the nature of the CSLR's remit. The CSLR operator is not engaged in making findings of fact or substantive administrative decisions. Their primary task is to engage independent actuarial consultancies to determine the levies so its administrative operations and staffing requirements should be quite limited.

Section 1069Q of the *Corporations Act* states:

> *(1) The money of the CSLR operator is to be applied only:*
> > *(a) to pay compensation under section 1063; and*
> > *(b) to pay AFCA's unpaid fees under section 1069B; and*
> > *(c) to pay AFCA's accumulated unpaid fees under section 1069C; and*
> > *(d) to pay the CSLR operator's administrative costs; and*
> > *(e) to reimburse to ASIC the costs that ASIC has notified to the CSLR operator under subsection 9(4) of the Financial Services Compensation Scheme of Last Resort Levy (Collection) Act 2023; and*
> > *(f) to establish and restore the capital reserve (within the meaning of the Financial Services Compensation Scheme of Last Resort Levy (Collection) Act 2023).*

The essential role of the CSLR is to administer payments in accordance with decisions made by other government entities. This function should not require extensive back-office capabilities and administrative costs should be relatively low.

Noting that the CSLR outsources the processing of Dixon "surge" claims to an external vendor, the FSC does not consider the operator's present costs to be justified when the vendor could instead be engaged directly, which would allow the annual administration costs of $6.4 million to be spent on victim compensation or fee reduction.[36]

On this basis and as an accountability mechanism, the FSC supports imposition of a limitation on the funds raised by annual and special levies to prevent them from being spent on the CSLR operator's administrative costs. This would necessitate Government funding for

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[35] The Treasury, Compensation Scheme of Last Resort - Proposal Paper (treasury.gov.au), pp.17,19; Finity, CSLR paper, 1st & 2nd Levy Period Initial Estimates, March 2024, pp.46 and 56.
[36] Finity, CSLR paper, 1st & 2nd Levy Period Initial Estimates, March 2024, p.25.

the very modest annual expenditure that ought to be required to operate the CSLR, while earmarking funds collected from industry to be expended on victim compensation.

Recommendation #6: The FSC supports reducing CSLR operator costs by:

1. reducing the duplication of functions between AFCA and the CSLR operator; and
2. requiring the CSLR operator to focus on its core responsibilities to administer the CSLR without undertaking research, advocacy and policymaking activities.

As noted, the FSC considers that the CSLR operator's core responsibility is to distribute compensation to consumers as determined by AFCA. Nonetheless, the CSLR operator may presently undertake a number of advocacy and marketing activities which appear to stray beyond these core responsibilities.

Given the present strain on the CSLR operator's budget stemming from the Dixon cohort and the high likelihood of a special levy being imposed, the FSC does not consider it appropriate for the CSLR operator to undertake activities beyond those which are strictly required for it to perform its statutory functions.

If the CSLR operator continues to duplicate functions of AFCA, the FSC notes that under section 1060 of the *Corporations Act* it is possible for the entities to be merged, which might represent an alternative means of reducing the scheme's administration costs.

Recommendation #7: The FSC supports a one-off injection of government funding to fund claims arising from the Dixon Advisory collapse.

Expectations that Government and the pre-CSLR levy would jointly pay for Dixon claims

In September 2022, the present Government indicated:

> "*The Government will contribute towards the costs of the scheme in its first year of operation, **which is proposed to commence from 1 July 2023**. The scheme will be fully industry funded through a levy on relevant financial service and credit licensees **in the subsequent years of the scheme's operation**.*"[37] (emphasis added)

The role of the Government funding was reflected in the Explanatory Memorandum to the package of legislation implementing the CSLR, which stated:

[37] The Hon Stephen Jones MP, Assistant Treasurer and Minister for Financial Services, Media Release: Hayne Royal Commission recommendations advanced, 8 September 2022.

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"*The first levy period begins on the day specified in a determination made by the Minister and ends on 30 June 2024.*

*"**The costs for the first levy period are to be funded by the Commonwealth**. For all subsequent levy periods, the levy amount for the levy period is required to be paid by parts of the financial services industry."*[38] (emphasis added)

The Explanatory Memorandum made it clear that the Government funding would be in addition to a pre-CSLR levy imposed on the 10 largest banking and general/life insurance groups. The explanatory memorandum explained the pre-CSLR levy as follows:

"*Australia's ten largest banking and insurance groups (excluding health insurers and superannuation groups) are also required to pay a one-off levy **to fund the backlog of accumulated unpaid claims (and AFCA's unpaid fees relating to those claims) relating to complaints made to AFCA between 1 November 2018 and 7 September 2022."***[39]

The CSLR operator's actuaries determined that of 1,638 AFCA complaints made between 1 November 2018 and 7 September 2022, an estimated 95% (1,556) would be found eligible for CSLR compensation.[40] Consequently, the pre-CSLR levy was set at $241 million, of which $203 million was earmarked for Dixon claims.[41]

However, complaints against Dixon continued to be received after the pre-CSLR levy period. This was anticipated by Treasury. Documents released under freedom of information processes indicate the Government nonetheless decided to retain the cut-off date of 7 September 2022 for the pre-CSLR levy period when designing the final version of the CSLR bills.[42]

By 30 June 2024, AFCA had registered a total of over 2,773 complaints against Dixon, meaning an additional 1,135 complaints had been received since 8 September 2022.[43] Since the pre-CSLR levy had been designed to raise funds for complaints lodged no later than 7 September 2022, the funds raised by the pre-CSLR levy are not expected to sufficiently fund the new complaints, a high share of which are – based on previous actuarial estimates – expected to be eligible for CSLR compensation.

It is important to note that as set out above, a clear expectation was set by the Government that most claims from the Dixon collapse would be paid out from 1 July 2023[44] to 30 June

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[38] Parliament of Australia, Explanatory Memorandum, Treasury Laws Amendment (Financial Services Compensation Scheme Of Last Resort) Bill 2023; Financial Services Compensation Scheme Of Last Resort Levy Bill 2023; and Financial Services Compensation Scheme Of Last Resort Levy (Collection) Bill 2023, 8 March 2023, p.32.
[39] Parliament of Australia, Explanatory Memorandum, Treasury Laws Amendment (Financial Services Compensation Scheme Of Last Resort) Bill 2023; Financial Services Compensation Scheme Of Last Resort Levy Bill 2023; and Financial Services Compensation Scheme Of Last Resort Levy (Collection) Bill 2023, 8 March 2023, p.41.
[40] Finity, Pre-CSLR Complaints Initial Estimate, December 2023, p.24.
[41] Finity, Pre-CSLR Complaints Initial Estimate, December 2023, p. 32.
[42] Treasury, Treasury submission MS23-000300 to the Minister,17 February 2023, p.8.
[43] Australian Financial Complaints Authority, Dixon Advisory and Superannuation Services Pty Ltd (Subject to Deed of Company Arrangement), September 2024.
[44] The start date of the scheme originally announced by the Government.

2024[45] and be covered jointly by the pre-CSLR levy and Government funding.[46] This expectation was made clear on 8 September 2022,[47] and materials released through freedom of information processes show that the Minister was advised by a submission dated 12 August 2022 that it was "*possible, though unlikely*" Dixon costs end up "*exceeding $250 million*", which would "*expose the Government to increased costs in the first levy period (2023-24)*".[48] Such wording clearly demonstrates the Government intended to contribute to the costs of the Dixon cohort.

An unexpected burden on financial advice licensees

A series of delays pushed the processing of Dixon complaints into levy periods which were technically no longer covered by the Government's commitment to jointly fund the first year of the scheme:

- the legislation was not passed until June 2023;
- the enabling regulations were not created until 31 January 2024;[49]
- AFCA did not publish its lead determination to guide the assessment of Dixon cases until 6 February 2024;[50]
- the CSLR's first levy period did not commence under the regulations until 2 April 2024;[51] and
- AFCA paused the processing of complaints until 2 April 2024.[52]

Consequently, the period of Government funding was limited to 2 April 2024 to 30 June 2024. This period was too short to resolve the outstanding Dixon claims. In fact, during this period the CSLR paid out zero Dixon claims.[53]

As a result of these delays, the prospect of the Government providing financial support to the CSLR to assist with the Dixon cohort appears to have receded. Yet delays had been anticipated by Treasury: advice released under freedom of information laws was that a minimum of 8 months would be required after the passage of the CSLR legislation for the scheme to become operational.[54] This expectation and its implications for joint Government funding of Dixon claims was not made clear to industry.

While much of the $203 million collected from the 10 largest banking and general/life insurance groups earmarked for Dixon claims remains available to compensate the 1,638 Dixon cohort members who lodged their AFCA complaints by 7 September 2022, on the

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[45] The end date of the first levy period specified in the legislation.
[46] Chris Dastoor, 'Deep concern' as govt sidesteps Dixon-related CSLR liabilities, *Professional Planner*, 19 March 2024.
[47] The Hon Stephen Jones MP, Assistant Treasurer and Minister for Financial Services, Media Release: Hayne Royal Commission recommendations advanced, 8 September 2022.
[48] Treasury, Treasury submission MS23-000300 to the Minister,17 February 2023, p.3.
[49] Treasury, Financial Services Compensation Scheme of Last Resort Levy (First Levy Period) Determination 2024, paragraph 5.
[50] Australian Financial Complaints Authority, Determination, Case Number: 716627, 6 February 2024.
[51] Treasury, Financial Services Compensation Scheme of Last Resort Levy (First Levy Period) Determination 2024, paragraph 5.
[52] Australian Financial Complaints Authority, Dixon Advisory and Superannuation Services Pty Ltd (Subject to Deed of Company Arrangement), 2 September 2024.
[53] Compensation Scheme of Last Resort, CSLR Impact Report, 2024, p.13.
[54] Treasury, Treasury submission MS23-000300 to the Minister,17 February 2023, p.14.

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back of the subsequent 1,135 complaints the CSLR operator has indicated that the $20 million sub-sector cap for financial advice licensees will be exceeded in FY26.[55] This raises the likely prospect of a special levy on licensees and/or other sub-sectors to pay for further Dixon compensation.

Importantly, the special levy mechanism was never intended to be used to fund Dixon claims. The Explanatory Memorandum indicates:

> "*Given the forward-looking nature of the CSLR levy framework (that is, that the levy is based on estimates of costs for the upcoming levy period), it is appropriate and necessary for the Minister to be able to intervene in situations where the CSLR operator requires additional funding to meet higher than expected costs for the levy period, such as where a large financial services provider becomes insolvent, or where a "black swan" event occurs in the financial services industry. These types of events may lead to a significant increase in the number and size of compensation payments required to be made under the CSLR. As these circumstances are often not foreseeable, a Ministerial determination is necessary to ensure that the CSLR operator has the funds needed to make compensation payments to consumers as quickly as possible.*"[56]

A historical company collapse which predates the existence of the CSLR itself cannot be construed as an unanticipated "*black swan*" event.

In light of the Government's previous representations about contributing to the CSLR during its first year of operation, the FSC strongly supports a one-off Government contribution to the CSLR to resolve legacy Dixon issues and place the CSLR on a sustainable, future-focused foundation. This will be essential for the CSLR to face anticipated future challenges, such as the United Global Capital cohort (whose status is indeterminate as at the date of this submission).

Recommendation #8: The FSC recommends that, in addition to a one-off injection of government funding, the Minister stagger the CSLR levies or charge the levies by instalments to assist advice licensees in bearing the costs when there are large-scale incidents that are to be covered by the CSLR levies such as the Dixon Advisory claims.

In addition to direct Government funding (see recommendation 7), in order to help smooth payments, the Government could loan the CSLR operator further capital required for Dixon payments. This loan could be repaid incrementally from future annual levies paid by financial

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[55] Compensation Scheme of Last Resort, Compensation Scheme of Last Resort hosts first financial industry forum, 23 October 2024.

[56] Parliament of Australia, Explanatory Memorandum, Treasury Laws Amendment (Financial Services Compensation Scheme Of Last Resort) Bill 2023; Financial Services Compensation Scheme Of Last Resort Levy Bill 2023; and Financial Services Compensation Scheme Of Last Resort Levy (Collection) Bill 2023, 8 March 2023, p.55.

advice licensees. This would smooth out the impact of the Dixon cohort on CSLR levies payable by financial advice licensees.

Recommendation #9: The FSC recommends that, in the event that CSLR levies cannot be staggered for financial advice licensees, the Minister stagger the payment of individual compensation awards across multiple years to smooth the impact of one-off large-scale collapses of wealth management companies.

Strain on the CSLR might also be further reduced if the CSLR operator could spread out the payment of compensation lump sums over time. Such a power is provided to the Minister by section 1069H(3) of the *Corporations Act*, but is limited to circumstances where a revised estimate for a specific levy period has been provided to the Minister by the CSLR operator.

The existence of a broader discretion in the hands of the CSLR operator would give it more flexibility to manage its cash flows. It would also enable the CSLR operator to respond proactively to the collapse of wealth management companies and large anticipated cohorts of future claims (such as the United Global Capital cohort). For example, where a large cohort of future potential claims is identified, the CSLR operator might expedite the processing of other on-hand claims and plan to stretch out the processing of anticipated new claims, with the objective of smoothing out its cashflows and minimising the likelihood of special levies being imposed.

Staggering the payment of CSLR compensation would also help to mitigate some of the moral hazards associated with the scheme. For example, a longer payment timeframe will give ASIC, AFCA and the CSLR more time to detect fraudulent claimants who are attempting to defraud the scheme, while also deterring carelessness by consumers of financial products.

Given the amount of time which has elapsed for pre-CSLR levy claims, the FSC would support applying such a change on a prospective basis.

Recommendation #10: The FSC recommends the scheme operator should enforce subrogation rights to backdated claims. This includes the CSLR operator, or ASIC, using reasonable endeavours to pursue recovery under the financial services provider's professional indemnity insurance policy for the benefit of investors.

Section 1069A of the *Corporations Act* provides for the subrogation of rights and remedies against the entity in respect of which compensation was paid, provided the entity is a "*Chapter 5 body corporate*",[57] a description which captures:

> "*a body corporate:*
>
> *(a) that is being wound up; or*
>
> *(aa) that is a CCIV of which one or more sub - funds is being wound up; or*
>
> *(b) in respect of property of which a receiver, or a receiver and manager, has been appointed (whether or not by a court) and is acting; or*
>
> *(c) that is under administration; or*
>
> *(d) that has executed a deed of company arrangement that has not yet terminated; or*
>
> *(da) that is under restructuring; or*
>
> *(db) that has made a restructuring plan that has not yet terminated; or*
>
> *(e) that has entered into a compromise or arrangement with another person the administration of which has not been concluded.*"

The Explanatory Memorandum clarifies in relation to subrogation that:

> "*The purpose of this provision is to enable the CSLR operator, in certain circumstances, to recover some or all of the compensation paid on behalf of the relevant entity. It is also intended to prevent situations where the consumer is paid more than the amount specified in the relevant AFCA determination by receiving a compensation payment under the CSLR and a payment as a creditor to an insolvency process.*"[58]

The FSC strongly supports the proactive use of subrogation powers by the CSLR operator to recover funds from collapsed wealth management companies and their insurers.

Recommendation #11: The FSC recommends the Government should consider strengthening the CSLR's subrogation rights, by imposing an obligation to use reasonable endeavours (i.e. not solely providing the CSLR operator a right) to pursue recovery. Consideration should also be given to imposing a legal requirement for financial services providers to provide a copy of their professional indemnity insurance policy to the scheme operator where the financial services providers have unpaid AFCA claims.

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[57] Definition at *Corporations Act 2001* (Cth), section 9.
[58] Parliament of Australia, Explanatory Memorandum, Treasury Laws Amendment (Financial Services Compensation Scheme Of Last Resort) Bill 2023; Financial Services Compensation Scheme Of Last Resort Levy Bill 2023; and Financial Services Compensation Scheme Of Last Resort Levy (Collection) Bill 2023, 8 March 2023, p.23.

The FSC considers it important for the CSLR operator to be obliged to thoroughly assess whether funds may be recovered through its subrogation powers. This should be framed as a duty to use reasonable endeavours to achieve cost recovery, rather than a right to pursue it.

This is because – in line with the CSLR's objective of enhancing accountability – the first port of call for CSLR funding should be the entity responsible for a claim, or failing this, its insurer.

To facilitate the exercise of these rights, FSPs with unpaid AFCA claims should also be legally required to disclose a copy of their professional indemnity insurance policy to the CSLR operator. Alternatively, ASIC should be authorised to provide the CSLR operator with the latest copy of a PI insurance policy provided to them during the AFS licence registration/renewal process.

Recommendation #12: The FSC recommends the Committee investigate the possibility of increasing the priority given to the CSLR operator's creditor claims in liquidation or other means of streamlining subrogation rights to ensure the CSLR operator's claims are not prejudiced by statutory processes.

The FSC notes that under section 1069A of the *Corporations Act*, the CSLR operator may only exercise subrogated rights once compensation has been paid. In practice, this means that before the CSLR operator may exercise its subrogation rights, it is first necessary for:

1. AFCA to award compensation;
2. the complainant to file a request for compensation with the CSLR operator;
3. the CSLR operator to be satisfied that the complainant is eligible for compensation;
4. the CSLR operator to offer the complainant compensation;
5. the complainant to accept the offered compensation; and
6. the CSLR operator to pay compensation.

This can result in substantial delays, many of which are outside of the CSLR operator's power to control. This may prejudice the CSLR operator's standing in any insolvency. For example, the CSLR operator may, depending on the relevant proof of debts cut-off date, be forced to file out of time and accordingly receive a lower level of priority (or share of the insolvency assets) over the remaining assets of a Chapter 5 body corporate than otherwise would have been the case for an unsecured creditor in its shoes. This would place greater, unnecessary pressure on other CSLR funding sources.

The FSC recommends the Committee investigate this concern and if it is well-founded, and consider the merits of either giving CSLR operator debts priority unsecured creditor status or another means of streamlining the operation of subrogation rights. The FSC notes that while CSLR operator claims should increase in priority, it should not supersede existing PI

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insurance claims. Maintaining PI insurance claim priority is crucial as it represents the first line of protection and primary risk management tool. Any streamlining of subrogation rights should maintain focus on pursuing the perpetrators of misconduct and their parent companies.

Recommendation #13: The FSC recommends ASIC should be encouraged to exercise its power under section 915H of the ***Corporations Act*** to require a licensee to hold PI insurance for the same length of time as ASIC requires the licensee to maintain AFCA membership after its license is cancelled.

ASIC should be encouraged to exercise its power under section 915H of the *Corporations Act* to require a licensee to hold PI insurance for the same length of time as ASIC requires the licensee to maintain AFCA membership after its license is cancelled. ASIC typically requires a licensee to maintain AFCA membership for 12 months after the license cancellation to allow clients a reasonable time to bring a complaint. ASIC should require licensees to maintain their PI insurance until their AFCA membership is ceased. This will strengthen the likelihood of insurance cover being available to meet the costs of any AFCA determination and reduce reliance on the CSLR.

Recommendation #14: The FSC recommends ASIC should be encouraged to exercise existing powers under s920A(1)(j) and (ja) of the *Corporations Act* to ban a person linked to an AFSLs refusal or failure to pay AFCA determinations.

Section 920A(1)(j) of the *Corporations Act* empowers ASIC to take action against licensees who do not comply with their financial obligations, including banning or suspending those who fail to meet AFCA's compensation rulings at least twice.[59] ASIC announced on 19 August 2024 that for the first time it had exercised its power to cancel an AFS licence following the payment of funds by the CSLR.[60] In addition, on 11 October 2024 ASIC announced it had cancelled a further two AFS licences on grounds including failure to be a member of AFCA.[61]

By more consistently and publicly exercising such powers, ASIC could significantly deter non-compliance, ensuring that licensees either meet their compensation obligations or are removed from the market. This would enhance the integrity of the financial advice sector and reinforce the idea that regulatory bodies will not tolerate firms that attempt to evade financial responsibility, ultimately protecting consumers and encouraging higher standards across the industry.

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[59] Treasury, Attachment 1: Disciplinary Process – ASIC and the FSCP, 2021.
[60] Australian Securities and Investment Commission, ASIC cancels licence of Libertas Financial Planning,19 August 2024.
[61] Australian Securities and Investment Commission, ASIC cancels two Australian financial services licences and 11 Australian credit licences, 11 October 2024.

Incorporating this enforcement mechanism would also reduce the burden on the CSLR, as it would prevent bad actors from failing to meet obligations in the first place. This proactive measure helps shift responsibility back to licensees, ensuring that compensation determinations are paid, and reducing the need for the CSLR to step in to resolve unpaid claims.

Recommendation #15: The FSC recommends the annual report published by the CSLR operator should include:

- information by entity name and also by subsector when outlining the number and value of payments of compensation made during the levy period;
- information about the size of the entity (e.g. sole operator) and the reason for the unpaid determination (e.g. insufficient capital to fund the excess under the PI policy), as opposed to information about the types of products and/or services covered by the relevant AFCA determinations;
- information on any monies the CSLR operator has recovered under the subrogation rights and any expenses associated with the recovery;
- in relation to any compensation claim paid by the CSLR operator, whether the operator exercised its right of subrogation and pursued compensation under a relevant professional indemnity policy and, if not, a clear explanation as to why it did not take these actions.
- a balance sheet for each sub-sector to show whether there are any reserves attributable for each sector at the end of each levy period.

Noting concerns set out above at recommendations 5-6 and 10-11 about the CSLR operator's administration costs and the advantages of the more aggressive use of subrogation powers, the FSC supports the introduction of greater transparency in the CSLR operator's annual reports.

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4. Recommendations for preventing/mitigating the collapse of wealth management companies

Recommendation #16: The FSC recommends Treasury explore the viability of professional indemnity and capital adequacy requirements for advice licensees to reduce the burden on the CSLR.

Strengthening regulatory licensing settings for Advice Licensees is an important element that should be considered in reducing the burden on the CSLR by proactively addressing financial risks before they impact consumers. Introducing greater oversight of Professional Indemnity (PI) insurance requirements and imposing appropriate capital requirements for advice licensees could ensure that firms are better positioned to meet compensation obligations.

Currently, ASIC's cash needs requirements only mandate that licensees hold enough cash to cover 12 weeks of liabilities (see ASIC Regulatory Guide RG 126), which is inadequate for addressing potential compensation claims, especially in cases involving PI insurance excesses.[62] By introducing minimum capital or liquid asset requirements, advice licensees would have the financial stability necessary to meet claims against them, reducing the likelihood of unpaid determinations. Importantly, introducing appropriate capital requirements does not need to result in prudential supervision. Rather, it can simply require minimum cash or liquid capital requirements as part of license conditions. These assets are then available to meet any consumer claims. This can be built up over time to streamline the introduction of such requirements. The appropriate amount of capital and PI insurance should be the subject of consultation with industry.

Furthermore, stronger regulatory oversight by ASIC would ensure that licensees are operating within a framework that aligns PI insurance excesses with minimum cash requirements, ensuring firms can effectively meet their financial obligations. By enforcing these measures, the overall risk of unpaid determinations would decrease, directly alleviating the pressure and improving the sustainability of the CSLR.

Recommendation #17: The FSC recommends ASIC review its AFSL and scheme registration processes, including the information it captures as part of an AFSL application and scheme registration forms/processes to capture enhanced data points that will lead to either a fast track or slow track registration processes depending on the particular MIS. These enhanced data points will inform risk-based surveillance processes at the outset, to be implemented following registration of a MIS.

[62] Australian Securities and Investment Commission, Regulatory Guide 166: AFS licensing: Financial Requirements, September 2023, p.17.

ASIC receives information about the scheme and its responsible entity via the AFSL application and the scheme registration process. ASIC can use this information to adopt a risk-based approach for AFSL application/scheme registration processes and use that information to inform forward looking surveillance processes.

The FSC suggests that ASIC should have additional rights to request sufficient information at the outset to allow it to identify schemes which require more detailed consideration and adopt a fast track and slow track registration process depending on the particular MIS. This would provide a streamlined registration process for REs who meet certain criteria and standards and a slower track for high risk and novel products like SIT.

The data collected from the registration process would inform ASIC's future surveillance processes with more oversight conducted on new licensees and/or schemes or those that have a prior history of poor regulatory compliance. This means appropriate ASIC resourcing (in terms of the level of skill, experience and staffing numbers) could be devoted to the more 'high risk' or 'novel' REs and MISs at the AFSL application and scheme registration processes.

This need not be cumbersome. ASIC could review its AFSL and scheme registration forms to capture relevant data such as:

- The capital adequacy position of the AFSL/Scheme;
- Historical compliance with conflicts priority rules within the best interests duty framework;
- Previous involvement of key personnel in the AFSL or RE board with failed entities;
- Proposed use of in-house products and associated products;
- Liquidity position;
- Proposed risk management frameworks;
- Prior experience of key personnel in operating a scheme such as the one proposed to be offered; and
- The level of complexity of the MIS.

ASIC could also monitor data obtained when there is a change of control of a licensee related to the controlling entity and changes in the boards and responsible managers which may occur during the life of the RE/ licensee. This data would be used to inform ASIC's risk management oversight processes. For example, funds flagged as novel or complex like the Sterling Income Trust could be subject to periodic desktop or even shadow shop style reviews.

FSC FINANCIAL SERVICES COUNCIL

5. Related recommendations

Recommendation #18: The FSC recommends the Government should adjust penalty structures to promote the de-risking of the financial advice sector.

Currently, penalties in the financial services sector, including for superannuation trustees, are calculated based on a company's group's annual revenue (up to 10% of the body Corporate group's annual turnover in the relevant period).[63] While this model ensures that penalties are proportionate to revenue, it may also discourage firms or advisers from joining larger corporate groups, creating the unintended consequence of industry fragmentation. Smaller licensees often have lower revenue, which may inadvertently lead to lighter scrutiny by the regulator and financial penalties.

While smaller licensees play an important role in the market, they can lack the robust compliance and risk management frameworks that larger groups have. This can lead to increased consumer risks.

Recognising this, the FSC submits that a recalibrated penalty framework could be explored to support a wide range of business models while acknowledging the critical role larger and more resourceful firms play in contributing to industry stability and risk mitigation.

Recommendation #19: The FSC supports improving decision-making by AFCA to ensure CSLR payments occur in a consistent, transparent and accountable manner, and making assessments more rigorous through the involvement of a contradictor to scrutinise compensation claims.

The FSC notes concerns among industry that AFCA's approach to awarding compensation has in some instances become misaligned with the legislation which it is tasked with administering. It also underscores the importance of ensuring AFCA administers its caseload consistently, accurately and transparently.

By way of example, it is important to ensure that the $150,000 cap on compensation is applied consistently. Similarly, the requirements for a formal complaint under section 1065 of the *Corporations Act* need to be carefully observed.

In cases where a wealth management company has collapsed and it is no longer represented before AFCA, the Government should introduce an independent contradictor into AFCA's dispute resolution process to increase accountability, accuracy and consistency

[63] Australian Consumers and Investments Commission, Fines and Penalties, July 2024; *Corporations Act 2001* (Cth), ss 9 (definition of "annual turnover"), 1311C(3) and 1317G(4).

in its decision-making. This would also increase trust in AFCA's assessments from both consumers and industry.

The FSC notes that the CSLR is required to pay unpaid AFCA fees for cases eligible for CSLR compensation, even in cases where complaints are unsuccessful (sections 1069B and 1069C of the *Corporations Act*). Since the purpose of introducing a contradictor would be to reduce administrative expenses associated with the CSLR, the FSC opposes steps to charge the CSLR for the costs associated with a contradictor – particularly in instances where a complaint is ultimately unsuccessful.

Recommendation #20: The FSC recommends clarifying the application of special levies in circumstances where FSPs have divested themselves of leviable entities.

Sections 18 of the *Financial Services Compensation Scheme of Last Resort Levy Act 2023* and sections 28 and 29 of the *Financial Services Compensation Scheme of Last Resort Levy (Collection) Act 2023* operate to ensure that levies can be charged to their overarching corporate group instead of the relevant leviable entity in its own right.

The FSC understands that under one interpretation of the CSLR's enabling legislation, there is the possibility that any special levy imposed in FY26 would be based on data as at 30 June 2024.

The FSC has been informed that this has the potential to create issues for large FSPs which have in the intervening period divested themselves of their leviable entities (or the underlying assets which made them meet the definition of a leviable entity). For instance, an FSP which divested itself of a financial advice licensee effective from 1 January 2025 might still find itself paying the licensee's special levy in November 2025, because the relevant financial advisers were on its books on 30 June 2024.

The FSC therefore urges ASIC to ensure that it directs levies towards the appropriate entities and strongly recommends the committee support changes to the underlying legislation to clarify the operation of special levies in such circumstances.