From the Desk of Director Andy Semple

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Post-Implementation review: Compensation Scheme of Last Resort

The Association of Securities and Derivatives Advisers of Australia (ASDAA) appreciates the opportunity to provide these comments to The Treasury in respect of the Compensation Scheme of Last Resort Post-Implementation review.

ASDAA is an association which represents its members from the Securities and Derivatives advisory profession. Its members are comprised of individuals who are either directors or employees of firms which hold Australian Financial Services Licences (AFSLs).

ASDAA has a strong desire to raise professional standards and improve investor protection. ASDAA members rely on the ongoing trust of their clients and on the integrity of the Australian financial markets for their livelihood. Without both, clients wouldn't participate in the markets and trade in shares, exchange traded options and other listed financial products.

By being financial product advisers, ASDAA members have been caught up in the various findings and recommendations of recent reviews, including the Compensation Scheme of Last Resort, notwithstanding that the problems that gave rise to these reviews/events, and to the significant public debate over the last few years, have occurred in the financial planning/wealth management areas, and not in relation to the Securities and Derivatives advisory profession.

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ASDAA are writing to express our deep concerns regarding the operation and impact of the Compensation Scheme of Last Resort (CSLR), particularly in light of the recent findings that the levy for the financial advice sector for FY2025-26 is set to hit an unprecedented $70.11 million.

Moral Hazard:

The CSLR, while designed with noble intentions to protect consumers, inadvertently introduces a significant moral hazard. The scheme creates a scenario where financial service providers might feel less compelled to maintain high standards of conduct, knowing there's a safety net to compensate consumers for their failings. This is particularly evident when we consider:

- **Industry Burden**: As reported by ifa.com.au, the financial advice sector faces a levy that exceeds the sector cap by more than three times, amounting to an existential threat to many advisers. This disproportionate financial burden suggests that the CSLR might be encouraging lax behavior, where the cost of misconduct is socialised across the sector rather than borne by the offending parties alone.

- **Disproportionate Financial Impact**: The financial advice sector faces a levy of $70.11 million for FY2025-26, far exceeding the $20 million sector cap. This not only punishes the many for the misdeeds of the few but also suggests that the CSLR has a perverse incentive structure, where the consequences of misconduct are not adequately borne by those responsible.

- **Incentivising Misconduct:** By spreading the cost of misconduct across all advisers, there's a risk that the system inadvertently encourages risky behavior, knowing that the industry will bear the cost rather than the individual or firm responsible.

Unsustainability and Unintended Consequences:

The recently announced levy of $70.11 million, largely due to claims against firms United Global Capital (UGC) and Dixon Advisory, illustrates the CSLR's failure to achieve a balanced, sustainable model:

- **Sectoral Impact**: The levy's staggering increase threatens the viability of the financial advice sector. This not only contradicts the scheme's aim of fostering consumer confidence but also risks reducing the availability and quality of financial advice, ultimately harming the very consumers the CSLR aims to protect.

- **Misaligned Incentives**: The scheme's current structure might inadvertently punish those advisers who operate responsibly, as they are pooled together with the few who cause significant financial harm, leading to an inequitable distribution of responsibility and cost.

- **Unsustainable Model**: The levy's dramatic increase, largely due to claims from specific failed entities, shows that the CSLR is not sustainable in its

current form. It's not fostering a culture of accountability but rather one where the financial advice sector is collectively punished for systemic failures.

Government Responsibility and Financial Equity:

- **Moral and Financial Responsibility**: If the CSLR is meant to compensate consumers for the failures of the financial advice sector, then the government, which regulates and oversees this sector, should share in the responsibility for any systemic failures or policy oversights that lead to such high compensation demands. The government's role in setting up, managing, and now addressing the shortcomings of the CSLR cannot be ignored.

- **Need for Governmental Financial Contribution**: If the CSLR is to continue in any form, the government must take financial responsibility for its part in the scheme's design and oversight and pay the short fall above the $20 million sector cap. The current model where the industry alone shoulders the entire cost of government policy failures is untenable.

Decline in Adviser Numbers:

- **From 2019 to 2023:** There was a notable decline in the number of financial advisers, with numbers dropping from 27,959 in 2019 to 15,819 by 2023. This represents a significant reduction of 43.4% over these years, influenced by factors like regulatory changes such as Industry Funding, insanely high professional indemnity insurance premiums, the inclusion of unnecessary educational requirements which were later grandfathered when it was too late, and the fallout from the Hayne Royal Commission which led to a lot of adviser experience exiting the industry.

- **2023-2024:** The financial year 2023-2024 saw a net loss of 214 advisers, which was still a better outcome compared to the previous year's loss of 633 advisers. This indicates a slowing of the decline, suggesting some level of stabilisation.

- **Early 2025:** Reports indicate that adviser numbers have been "quietly turning positive" over the past six months before this date, with numbers growing but still below the 15,500 mark. This suggests a cautious optimism about the sector's recovery or stabilisation, but it would be foolish to suggest the adviser decline has “bottomed out.” The gain of new advisers has come at the expense of advisers with 30 years plus experience leaving the industry.

  The added financial strain from the CSLR, combined with other regulatory costs like the ever increasing Industry Levy and the need for costly professional indemnity insurance thanks in no part to low bar but high cost detrimental AFCA compensation decisions, has been cited as other factors in advisers continuing to leave the profession.

Fun Fact!

The Securities Dealers Graduated fee from the Industry Funding levy is up **733%** since FY 19 20! In FY 19 20 it was $0.03 per $10,000 of transactions. For FY 23 24 it was $0.25 per $10,000 of transactions.

The Adviser Levy fee component is up a 'modest' **135.7**% since FY 18 19.
In the two years of COVID (FY 20/21 & FY 21&22) it was reduced 53%

ASDAA is fairly confident that no SME FSP's have experienced a 135.7% let alone 733% increase in revenues in the same periods.

Elephant in the Room

The Compensation Scheme of Last Resort (CSLR) was established to provide a safety net for consumers who suffer financial harm due to misconduct or negligence within the financial services sector. However, the current framework harbors an elephant in the room: the exclusion of Managed Investment Schemes (MIS) issuers from contributing to the CSLR levy. This exclusion not only undermines the scheme's equity but also its effectiveness in protecting consumers across all financial products.

The Current Inequity:

- **Levy Application:** The CSLR levy is currently applied to sectors such as financial advice, credit intermediation, and securities dealing for retail clients, while MIS issuers are conspicuously absent from this obligation. This discrepancy results in an unfair distribution of financial responsibility, where the burden falls disproportionately on financial advisers and other sectors for failures that can stem from the products themselves, including those managed by MIS issuers.

- **Case Example** - Dixon Advisory: The collapse of Dixon Advisory and Superannuation Services, primarily due to their involvement with the US Masters Residential Property Fund (an MIS), illustrates how consumer losses can be directly linked to the mismanagement or failure of MIS. Yet, under the current rules, the financial advice sector alone bears the cost of compensation through the CSLR levy, despite the product-related roots of the problem.

Why Change is Necessary:

- **Consistency in Liability:** Both financial advisers and MIS issuers deal with market risks and potential company failures. If a stockbroker can be held liable for recommending a failing stock, why should an MIS issuer escape responsibility when their scheme includes the same stock? The inconsistency here is not only illogical but also unjust.

- **Enhanced Consumer Protection:** Including MIS issuers in the CSLR would ensure a more comprehensive consumer protection framework. Consumers investing in MIS often do not have the same level of understanding or risk assessment capabilities as professional investors. They deserve the same protection from misconduct or negligence as those receiving direct financial advice.

- **Fair Distribution of Financial Burden:** The current setup places an undue financial strain on certain sectors, particularly financial advisers, for losses that are sometimes out of their control. Spreading this burden to include MIS issuers would reflect a more equitable approach to managing the fallout from financial sector failures.

- **Prevention of Misconduct:** By making MIS issuers financially accountable for consumer losses linked to their schemes, there would be a stronger incentive for due diligence, transparent marketing, and ethical management practices. This could lead to a reduction in the number of schemes that fail due to mismanagement or misrepresentation.

ASDAA acknowledges the following Challenges and Considerations:

- **Legislative Action:** Extending the CSLR to include MIS issuers requires legislative change, which involves navigating political, industry, and regulatory landscapes.

- **Risk Differentiation:** There must be clear guidelines distinguishing between market risk and actionable misconduct to prevent moral hazard while ensuring justice for consumers.

- **Sector Impact:** The inclusion needs careful consideration to not disproportionately affect innovation in investment products but rather guide it towards more consumer-centric practices.

In light of the significant disparities and inefficiencies highlighted in the current application of the CSLR, there is a compelling case for its disbandment.

Why the CSLR Should Be Disbanded:

- **Ineffectiveness in Purpose**: If the CSLR cannot protect consumers without endangering the sector meant to serve them, it fails its primary objective. The high levy not only strains the industry but also raises the cost of advice, potentially driving consumers away from seeking professional guidance.

- **Uniform Consumer Protection**: The CSLR, as currently structured, fails to achieve its goal of uniform consumer protection. The inequity where financial advisers bear the brunt of compensation costs for failures that can equally, if not more so, be attributed to the products they recommend (like MIS), points to a flawed design. This selective application of the levy does not reflect the interconnected nature of financial services where the failure of one product can be a result of multiple parties' negligence or misconduct, including those managing the investment vehicles.

- **Lack of Accountability**: The current system dilutes the accountability of individual firms for their actions. Disbanding the CSLR would force firms to bear the direct consequences of their misconduct, thereby incentivising better practices.

- **Lack of Preventive Measures:** The scheme focuses too heavily on aftermath compensation rather than prevention, which does little to improve industry practices or consumer outcomes in the long term.

- **Retrospective Liability:** A significant portion of this levy relates to claims from past misconduct, notably from the failures of Dixon Advisory and UGC. This retrospective nature means current advisers are funding compensation for issues that occurred before the scheme's inception, which many in the sector argue is unfair.

- **Administrative Inefficiencies:** The need for frequent reviews, potential special levies, and the backlash from both the public and industry indicate that the CSLR is not functioning as intended. This suggests a system that requires constant adjustment rather than providing a stable, effective framework for compensation.

- **Opportunity for Reform:** Disbanding the CSLR could open the door to creating a new, more inclusive compensation mechanism. This would ensure that all parties in the financial ecosystem, including MIS issuers, contribute to and are held accountable for consumer losses due to misconduct or negligence.

- **Aligning with Financial Sector Principles:** A new system post-CSLR could better reflect the principles of fairness, comprehensive consumer protection, and accountability, aligning with the broader goals of the financial services sector in Australia.

The CSLR, in its current form, is not fit for purpose. It fosters not only a moral hazard but an economic one by placing an unsustainable burden on the financial advice sector, and fails to ensure that the costs of misconduct are appropriately allocated. Just as adviser numbers appear to be stabilising, the impact of the projected CSLR levy, projected to be around $70 million for the 2025-2026 financial year, directly threatens this stabilisation.

This burden could lead to:

- **Financial Strain:** Advisers face increased operational costs, potentially making the profession less financially viable, particularly for smaller firms or solo practitioners. The projected levy of around $70 million for the 2025-2026 financial year represents a significant financial outlay for advisers, particularly when individual advisers could face costs over $4,500 each.

- **Exit from the Profession**: The high costs associated with the CSLR might discourage advisers with a lot of experience from continuing in the industry, leading to an uptick in exits. This could reverse the positive trend in adviser numbers.

- **Deterrence for New Entrants:** The financial commitment required due to the CSLR levy could deter new advisers from joining the profession, impacting future growth.

- **Increased Costs to Consumers**: Advisers might need to pass on the increased levy costs to their clients, potentially making financial advice less affordable and accessible, which could counteract the stabilisation by reducing demand.

- **Future Planning:** The unpredictability of future levies, especially with the possibility of exceeding caps, makes it challenging for firms to plan financially, adding to operational uncertainty.

- **Unfair Cost Allocation:** The levy does not ensure that the costs of misconduct are borne by those directly responsible; instead, it's shared among all advisers, regardless of their involvement or ethical standing.

- **Calls for Review and Reform:** The situation has led to urgent calls for a review of the CSLR, with industry bodies such as ASDAA advocating for changes to ensure the scheme does not undermine the sustainability of the advice sector. This acknowledgment by the government for a comprehensive review suggests there's an understanding of the scheme's potential to disrupt the profession's recovery.

Given the significant financial impact on consumers and the industry from the failures of UGC and Dixon Advisory, can the government provide an update on the progress of asset recovery from the directors of these entities? This information would be invaluable for understanding the current state of compensation efforts, the effectiveness of existing regulatory tools, and the potential need for legislative or procedural enhancements.

It is surprising and concerning that, given the extent of the issues with Dixon Advisory, no directors have been banned by ASIC. This raises questions about the effectiveness of current regulatory measures in holding directors accountable for significant corporate failures.

It's a bitter pill to swallow being asked to pay for others' errors. It feels fundamentally unfair that current advisers are penalised for past misconduct they had no part in.

ASDAA strongly urges The Treasury to consider disbanding the CSLR in favour of a new system that fosters genuine accountability, reduces moral hazard, and ensures that consumer protection does not come at the expense of industry sustainability.

Bottom Line:

The Government's Role in CSLR Funding:

- **Funding Shortfall:** The government must commit to covering any shortfall in the CSLR levy that exceeds the $20 million sector cap. This is critical to ensure that the financial advice industry isn't disproportionately burdened by historical or unforeseen claims.

- **Sector Cap Adjustment:** The $20 million sector cap should only be adjusted in line with inflation, preventing arbitrary increases that could further strain the sector without justification.

Proposal for Support for Small Financial Service Providers:

- **10-Month Payment Plan:** Any increase in the cap or levy should come with provisions allowing small financial service providers (with operational revenue under $2 million) to pay the levy over a 10-month payment plan. This would:

    - **Eligibility:** Be strictly for firms meeting the revenue threshold, ensuring that relief is targeted where it's most needed.

    - **Terms:** Payments would be made in equal installments over 10 months, with no interest, to ease cash flow pressures.

    - **Implementation:** Requires clear guidelines, an easy application process, and strong oversight to ensure compliance and effectiveness.

Rationale:

- **Equity:** Ensuring government funding for the excess over the cap recognises the public good aspect of consumer protection while preventing the collapse of the advice sector under financial strain.

- **Industry Sustainability:** High levies threaten the existence of small practices, potentially leading to a less competitive and less innovative advice sector.

- **Sustainability:** By only adjusting the cap with inflation and offering payment plans, we maintain industry diversity and accessibility, supporting both advisers and consumers.

- **Accountability:** This approach encourages better regulatory practices, as the government has a direct stake in managing and preventing consumer harm.

Proposal for Tax Deductibility:

- **Current Status as Business Expense:** The levy is already recognised in financial statements as a business expense, directly affecting the profitability of advisory firms.

- **Proposed Tax Deductibility:** ASDAA propose that the CSLR levy be made tax-deductible, allowing advisers to subtract this cost from their taxable income, thus reducing their tax liability.

Rationale:

- **Financial Relief:** This would provide tangible tax relief, effectively reducing the net financial impact of the levy on advisers.

- **Compliance Incentive:** By linking the levy to tax benefits, advisers are incentivised to comply with payment obligations, knowing there's a direct benefit at tax time.

- **Industry Sustainability:** For small to medium-sized practices, this could be crucial for maintaining operations and supporting industry diversity.

Proposal for the inclusion of Managed Investment Scheme (MIS) issuers to contribute to the CSLR levy:

- **Inequitable Consumer Protection:** The current CSLR fails to provide uniform consumer protection by excluding MIS issuers from levy contributions, leading to an unbalanced approach where financial advisers disproportionately bear the responsibility for product-related failures.

- **Establish a New Comprehensive Compensation Mechanism**: Develop and implement a new, inclusive compensation framework that involves all relevant sectors of the financial industry, including Managed Investment Scheme (MIS) issuers.

- **Broaden Contribution Base:** Ensure that the financial responsibility for consumer compensation is shared more equitably across all segments of the financial services sector.

- **Create a Unified Regulatory Approach:** Introduce consistent liability and accountability standards for all financial products and services providers.

- **Enhance Consumer Education:** Alongside the new compensation mechanism, strengthen consumer education to better inform individuals about the risks associated with various financial products, including MIS.

Rationale:

- **Inequitable Consumer Protection:** The current CSLR's exclusion of MIS issuers results in an unbalanced protection scheme, where only certain sectors bear the financial burden for widespread sector failures.

- **Lack of Accountability:** By not holding MIS issuers accountable, the current system may inadvertently promote less stringent management practices, potentially leading to more consumer detriment.

- **Financial Strain on Advisers:** The levy disproportionately affects financial advisers, potentially leading to higher fees for consumers, reduced

availability of advice, or advisers leaving the profession, which is counterproductive to financial literacy goals.

- **Administrative Inefficiencies:** The CSLR has required numerous adjustments, including special levies, indicating a system that is not only administratively cumbersome but also lacks a stable foundation for effective operation.

- **Need for Fair Contribution:** A new system would distribute the financial responsibility for consumer losses more equitably, reflecting the reality that misconduct or failures can stem from various points in the financial services chain.

- **Comprehensive Consumer Protection:** By including all sectors, a new mechanism could offer more thorough protection, ensuring that consumers are safeguarded regardless of the type of financial product involved in any misconduct.

- **Alignment with Industry Principles:** The proposed changes would better align the compensation framework with the principles of fairness, accountability, and consumer protection that should underpin the financial services sector.

The elephant in the room regarding the CSLR is the glaring omission of MIS issuers from its financial responsibilities. This not only creates an imbalance in how financial sector misconduct is addressed but also leaves a significant gap in consumer protection. The time has come to recognize this issue and take steps towards a more equitable, comprehensive, and just compensation framework. Including MIS issuers in the CSLR levy is a critical step towards ensuring fairness, enhancing consumer protection, and fostering a culture of accountability across all financial services sectors in Australia.

ASDAA implore The Treasury to adopt these measures to safeguard the financial advice industry's sustainability while upholding consumer protection. This balanced approach will promote genuine accountability and prevent the moral hazard associated with the current levy system.

ASDAA appreciates the opportunity to provide this Submission to The Treasury on these significant proposals. We would be happy to discuss any issues arising from our submission on this issue, or to provide any further material that may assist. Should you require any further information, please contact Brad Smoling, Director of Communications, on (07) 5532 3930 or email brad@asdaa.com.au

Yours sincerely,

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