Companies and Securities Advisory Committee

Consultation Paper

Retail Client Compensation in Financial Markets

September 2001

Part 1

Rationale and overview of the Client Compensation Scheme

Request from the Minister

The Minister for Financial Services and Regulation, the Hon Joe Hockey MP, by letter of 26 April 2001, requested the Advisory Committee to review compensation arrangements in the financial services sector and report by 26 January 2002. The Minister's request did not relate to clearing house support arrangements.

The Minister indicated that the Financial Services Reform Bill (FSRB), while containing some changes to the compensation provisions, did not represent the Government's final position, and that more detailed research and consultation were needed.

The Minister asked the Committee to:

- examine the merits of a compensation scheme and who should conduct it
- consider options in light of international precedents and developments, and
- undertake the necessary consultations, including with investor organizations

for the purpose of proposing a comprehensible and efficient compensation regime that will provide appropriate protection for investors.

Summary of the Scheme

The Advisory Committee proposes a Client Compensation Scheme (the Scheme) to compensate retail clients (as defined in the Financial Services Reform Act (FSRA)) when any licensed financial service provider (hereafter referred to as an "intermediary") with whom they have dealt is "insolvent" (that is, either where the intermediary is under some formal insolvency administration or is, in the opinion of the Scheme operator, unable to pay any amount due to a retail client). The Scheme would cover the return of client property held by the intermediary or losses to retail clients arising from any improper conduct by the intermediary, within prescribed caps.

The Scheme would complement the requirements in the FSRA that intermediaries have ASIC-approved dispute resolution and compensation arrangements for their retail clients.

If the Scheme is introduced, the additional FSRA requirement that individual market operators have approved client compensation schemes should be removed.

The meaning of "compensation" in the FSRA

The FSRA uses the term "compensation" in different senses:

- *clearing and settlement guarantee*, relating to clearing and settlement of transactions in financial products markets, including broker/broker claims. Compensation in this context is primarily concerned with overcoming counterparty and systemic risks and their possible contagion implications

- *client compensation*, relating to redress for loss or damage suffered by the client through breach of relevant obligations relating to the provision of financial services by financial services licensees or declared professional bodies.

Scope of the Paper

The Scheme proposed in this Paper is directed at:

- client compensation. Clearing and settlement guarantee arrangements are outside the terms of this review

- compensation in the specific context of financial services that are provided by intermediaries and involve securities, derivatives or interests in managed investment schemes, whether on- or off-market (referred to hereafter as "investments")

- the relationship between a retail client and an intermediary. Client compensation does not cover investors for any loss of value of their investments, other than claims by clients against their intermediaries for negligent advice.

Possible model for other compensation schemes

The Scheme outlined in this Paper covers only investments. However, the FSRA applies to deposits, superannuation and insurance as well as investments.

The Scheme could be a model for compensation in relation to these other financial products. However, it may be necessary to have separate compensation schemes or eligibility rules for each of these other financial products, as:

- the compensation criteria may need to be adjusted for different financial products. For instance, the losses that could be incurred by a retail client whose intermediary fails to properly follow instructions to enter into insurance contracts could be substantial. Compensation caps that might be appropriate for investments may be inappropriate for insurance contracts, and

- in the absence of separate schemes, intermediaries in some sectors of the financial market may cross-subsidise intermediaries in other sectors.

The UK scheme has sub-schemes for different financial products and rules for determining who are contributing intermediaries and how much they must contribute to each of these sub-schemes.

Compensation schemes for deposits, superannuation and insurance could be a matter for future review.

The need for the Scheme

Complementing FSRA investor protection requirements

The FSRA creates obligations and procedures to ensure that retail clients have accessible means to obtain redress in disputes with their intermediaries. However, these protections may only be fully effective while an intermediary is solvent. The Scheme would provide some protection to retail clients in the relatively infrequent instance where an intermediary becomes insolvent.

The FSRA requires intermediaries to have:

- internal and external dispute resolution procedures approved by the Australian Securities and Investments Commission (ASIC) for retail clients (primarily s 912A(g))
- ASIC-approved arrangements for compensating retail clients for loss or damage suffered through any breaches of the relevant obligations under the legislation (primarily s 912B).

ASIC has published a dispute resolution policy proposal to deal with complaints made by any retail client against a licensee about the provision of financial product advice or any other financial services (ASIC FSRB Policy Proposal Paper No 7 June 2001). These disputes could include allegations of negligent advice, breach of contract, maladministration of a client's property or failure to follow instructions.

Dispute resolution and associated compensation arrangements are effective only to the extent that:

- the intermediary can be required to pay any amounts awarded to retail clients, and
- those funds are available.

The first condition is satisfied by a requirement that intermediaries, as a condition of belonging to an approved dispute resolution scheme, comply with its determinations. The Scheme aims to protect investors by providing funds whenever an intermediary cannot pay legitimate retail client claims.

Replacing inappropriate FSRA requirements

In addition to the requirement on intermediaries, the FSRA requires each financial market operator to have client compensation schemes. However, the compensation criteria can differ between markets. For instance, the National Guarantee Fund (NGF) includes insolvency cover in some instances, whereas other financial market operators need only compensate for losses suffered through the defalcation or fraud of intermediaries (s 885C) and may exclude losses where retail clients have not made clear on what market their funds were to be invested (s 885D).

This piecemeal system can create inconsistencies and administrative complexities in awarding compensation, given that eligibility under a scheme operated by a particular market operator is based on establishing a connection between the actions of insolvent intermediaries and that market. It can also create possible overlapping sources of client compensation between financial market operator schemes and intermediary schemes. The existence of multiple schemes can result in investor confusion, forum shopping, potential inequality and fragmentation of avenues of redress.

Retail investors would be better protected by simplifying and streamlining the client compensation system as follows:

- remove all the obligations on financial market operators to have client compensation schemes
- rely solely on the ASIC-approved dispute resolution and compensation arrangements where intermediaries are solvent
- introduce a uniform capped compensation scheme as an adjunct to the above dispute resolution and compensation arrangements in the relatively rare, though potentially very detrimental, situations where an intermediary is insolvent, regardless of the particular financial market or markets in which the intermediary has traded on its clients' behalf.

Responding to market practices

The number of retail investors in Australian financial markets has been steadily increasing. Also, there is an increasing tendency for securities owned by retail clients to remain under the direct control of their intermediaries. This may increase the possibility of retail clients incurring losses if their intermediaries become insolvent or cannot pay.

Outline of the Scheme

In essence, the Scheme would:

- be operated by an independent body which may also have dispute resolution functions (see further **The Scheme operator**), with appropriate powers and duties (see further **Powers and duties of the Scheme operator**)
- apply only to retail clients of intermediaries, for the reasons outlined under **Eligible clients**
- employ eligibility criteria for compensation for financial services provided by intermediaries in relation to any investment. These criteria should include the same criteria as where the intermediary is solvent (see further **Matters covered by compensation**)
- compensate retail clients of insolvent intermediaries even where there is a chance of eventual recovery in an insolvency (see further **When**

compensation should be paid). The Scheme funds could be protected through subrogation (see further **Subrogation**)

- be subject to compensation caps and time limits on making claims (see further **Capping** and **Time limits for making claims**), and

- be funded by levies on intermediaries dealing in investments on behalf of retail clients (see further **Funding the Scheme**).

Transitional arrangements could deal with the transfer to the new Scheme of appropriate funds currently held by the NGF and the Sydney Futures Exchange (SFE) (see further **Transitional arrangements**).

Benefits of the Scheme

This insolvency-based Scheme would promote Australian financial markets in various ways.

- *Investor protection.* Retail clients are often not able to adequately assess in advance the risk of placing their funds with particular intermediaries. Also, they may have no realistic way to pursue their claims against intermediaries through other means, such as the courts. The Scheme would enable them to receive immediate and substantial, but not necessarily complete, compensation where the intermediary is insolvent. The criteria for compensation would be the same as those that apply where an intermediary is solvent (though compensation caps would apply under the Scheme).

- *Public confidence.* The Scheme may help maintain public confidence in participating in financial markets through intermediaries, or restore confidence in the event of the collapse of one or more intermediaries, should that occur. It would also avoid the problem of whether public revenue should be involved, given that the industry itself would fund the Scheme.

- *International competitive position.* The Scheme would accord with international precedent and, by applying to overseas as well as domestic retail clients of Australian intermediaries, would help maintain the competitive position of Australian financial markets. Outlines of the compensation schemes in the UK, the US and Canada, as well as Australia, are found in the Appendix to this Paper.

Any expectation that this Scheme may allow retail clients to trade without risk (which would create a moral hazard) could be reduced by:

- ensuring that the Scheme's limitations are widely understood, for instance, that it:

  - only protects retail clients of intermediaries

  - only deals with the relationship between the client and the intermediary. It does not cover losses arising from poor investment choices (market risk), other than claims by the client against the intermediary for negligent advice concerning those investments

  - imposes limits on the amount of compensation paid, which may therefore require clients to bear some of the risk

- requiring retail clients who seek compensation to subrogate their rights, thereby preventing any individual from “double dipping” against the funds of an insolvent intermediary.

An argument sometimes put is that client compensation where an intermediary is insolvent is not essential for investor confidence in the long run, given that markets can recover from the occasional insolvency, even of a large intermediary. However, this argument overlooks the considerable hardship that may be suffered by those retail investors who have no other realistic way to recover at least some of their lost funds.

Intermediaries would fund the Scheme. This may raise the concern that financially sound intermediaries are, in effect, collectively paying for the misconduct of insolvent intermediaries. However, if the Scheme’s costs are sensibly limited and kept within internationally competitive levels through appropriate capping of claims, those costs to intermediaries will be justified by the benefits of a well-publicized, easily accessible, understandable and expeditious compensation scheme which can provide substantial protection for retail investors, and may also encourage their greater participation in financial markets.

Comparison of the Scheme with current compensation entitlements

The Scheme, combined with the FSRA requirements for intermediaries to have ASIC-approved dispute resolution and compensation arrangements, would substitute for the FSRA obligation on each financial market operator to have client-intermediary compensation arrangements. To retain an additional compensation obligation on financial market operators could:

- be confusing for retail clients, particularly if a client had to seek compensation from several different schemes in the event that the insolvent intermediary traded on that client’s behalf in various markets. It could also create inequalities to the detriment of investors if different eligibility and recovery criteria applied in different markets. Either outcome would be contrary to the objective of ensuring that retail market participants can easily understand their rights and have confidence in being treated equally. By contrast, the Scheme would deal with all investments by an insolvent intermediary and apply the same compensation eligibility criteria, thereby providing more certainty for claimants and greater ease of administration

- increase regulatory responsibilities and costs, given the requirement under the FSRA for the regulator to assess the compensation scheme of each financial market operator. Multiple schemes could generate significant duplicate administrative costs.

Removing the obligation on financial market operators to operate client compensation schemes would also overcome the problem of the same pool of funds being used for clearing and settlement guarantee and client compensation, as permitted for the NGF under the FSRA. Overseas jurisdictions separate these arrangements. Financial market operators, or their clearing house operators, should retain responsibility only for clearing and settlement guarantees.

The Scheme would differ from the current financial market operator schemes (as summarised in the Appendix to this Paper) in various other ways.

- The NGF and SFE schemes provide compensation for some forms of improper behaviour even where the intermediary is solvent. Under the Advisory Committee's proposals, any dispute between a retail client and a solvent intermediary would be determined solely under the ASIC-approved mandatory dispute resolution and compensation requirements, with the Scheme providing compensation where the intermediary was insolvent. Retail clients would therefore retain effective avenues for redress through these combined processes, without the need for an additional scheme run by financial market operators. The effect would also be that defaulting intermediaries, rather than the industry, would pay whenever possible.

- There is no cap on NGF compensation, apart from insolvency. The SFE has a limit of $500,000 on total claims per broker. By contrast, the Scheme would have a cap per client per event: see further **Capping**, post. A cap achieves a more appropriate balance of legitimate interests by ensuring that industry contributors to the Scheme do not have a potentially unlimited exposure, while a sufficiently generous cap may cover all or most eligible losses by most retail clients.

Part 2

Elements of the Scheme

This Part discusses the principal elements of the Scheme, without developing the detailed administrative rules that would be required for its implementation. A summary of overseas compensation schemes is set out in the Appendix to this Paper.

The Scheme operator

Possible Scheme operators could include:

- *licensed market operators* (for instance, the current exchanges). Arguably, market operators would benefit from any client compensation scheme that encouraged retail participation in their markets. However, market operators can only be expected to administer schemes covering products traded on their markets. This can create complexities in apportioning losses where intermediaries have operated on their clients' behalf in various markets. Also, there can be considerable cost inefficiencies, including duplicate administrative structures if there are several compensation schemes. It is possible, but not inevitable, that various market operators may adopt the same compensation regime. Furthermore, requiring market operators to have compensation arrangements may discourage the development of some niche markets, unless some compensation exemptions were given

- *clearing and settlement facility licensees.* A client compensation scheme run by a clearing licensee may provide greater coverage than one operated by a licensed market operator. Clearing house schemes would cover all property lodged in connection with markets, whereas market operator schemes would be tied to market transactions. Nevertheless, an obligation on these licensees could lead to duplicate schemes, as well as complexities where a single intermediary is a participant in a number of different clearing houses

- *intermediaries individually.* The FSRA requires each intermediary that has retail clients, as a condition of obtaining or retaining a licence, to have satisfactory compensation arrangements for its retail clients. This requirement should remain. However, reliance on it alone may not adequately protect retail clients where an intermediary becomes insolvent

- *intermediaries collectively*, for instance, through a mutual entity of which all intermediaries are members. It is the insolvency of some of these intermediaries that creates the need for the compensation scheme. Also, solvent intermediaries derive direct benefits from a viable and liquid marketplace in which investor confidence is an essential element. A compensation scheme that supports investor confidence is therefore in their collective interests. They should at least be responsible for funding it

- *an independent entity* that operates the scheme in accordance with legislative criteria and/or regulations. The new UK scheme, summarized in the Appendix to this Paper, would be a precedent for this model.

An independent entity that deals with all compensation issues arising from the insolvency of an intermediary in relation to investments would:

- allow compensation rules to be developed and monitored through a process that takes into account and balances the interests of investors, the financial services industry generally and intermediaries. This could provide the necessary flexibility to adapt the Scheme to market evolution on a timely basis

- provide for a more broadly representative Scheme operator, by including persons with investor experience and appropriate corporate governance/public administration experience in addition to financial services representatives

- permit the development within one entity of expertise in dealing with financial markets compensation for all types of investments.

It is questionable, however, whether a separate body needs to be established solely to run a compensation scheme that would apply only in the relatively rare event that an intermediary becomes insolvent. One possibility would be for the Scheme to be run by an existing ASIC-approved industry dispute resolution body. This arrangement would also provide retail clients with access to one entity that could deal with their investments complaints against intermediaries, whether solvent or insolvent. However, unlike a dedicated dispute resolution body, any Scheme operator would be subject to substantially increased levels of external accountability, given that the operator would be raising and distributing compensation funds. Also, the Scheme operator would need additional powers to run the Scheme (see further **Powers and duties of the Scheme operator**, post).

Eligible clients

Retail clients only

Applying the Scheme to wholesale as well as retail clients (as defined under the FSRA) might bolster its role in diminishing the risks posed to market participants and the market generally by the insolvency of particular intermediaries.

However, the arguments for limiting the Scheme to retail clients include:

- wholesale clients may be better able than retail clients to assess the risk of dealing with particular intermediaries, or have a greater capacity to reduce risk either by diversifying their activities among several intermediaries or by obtaining insurance, if available, to cover any consequences to them of the insolvency of an intermediary

- any caps on compensation may still allow many retail clients to recover all or most of any eligible losses, whereas wholesale clients may only recover an insignificant proportion of those losses unless the caps were set very high

- limiting the Scheme to retail clients may substantially reduce the cost of the Scheme and/or increase funds available to compensate those clients

- under the FSRA only intermediaries to retail clients must have ASIC-approved compensation arrangements. If the Scheme is extended to wholesale clients, it would seem necessary to extend the FSRA obligation to wholesale-only intermediaries

- there are international precedents for limiting payments to retail clients.

The category of eligible claimants on Scheme funds should exclude any retail person who is associated with the insolvent intermediary. For instance, the UK scheme excludes from compensation arrangements:

- customers with a connection to the insolvent intermediary (for instance, directors, management, partners, certain shareholders, members of the same corporate group and the statutory auditor)

- anyone else who is judged to have had responsibility for, or profited from, the financial difficulties of the insolvent intermediary.

Nexus with Australia

One option would be for the Scheme to apply to any retail client, wherever located, who has dealt directly with an Australian intermediary, wherever located, in relation to any investments on any Australian exchange or OTC market. This would help promote Australian financial markets to overseas retail investors, who would be protected in their dealings with Australian intermediaries through a compensation scheme that compares favourably with the more limited coverage of overseas schemes (for instance, the UK scheme only applies where the intermediary is located in Europe).

The intermediary nexus requirement would also ensure that the Scheme only applies to the actions of those persons who are liable to contribute to the Scheme (see **Funding the Scheme**, post).

An issue is whether the nexus should extend to Australian intermediaries trading on an overseas exchange or OTC market.

Referral business

Retail persons may be the clients of one intermediary who in turn transacts on their behalf through a second intermediary. The Scheme would not protect the first intermediary (given that this entity is not a retail client) in the event of the insolvency of the second intermediary. However, the Scheme would protect retail clients of the first intermediary should it become insolvent (for instance, in consequence of the insolvency of the second intermediary).

Matters covered by compensation

From the perspective of comprehensive investor protection, the grounds on which retail clients may lawfully claim against intermediaries in relation to their investments should be the same whether the intermediary is or is not solvent.

The Scheme could achieve this goal by providing the following protections to retail clients of those intermediaries who are insolvent.

- *Return of client property (for securities and units in managed investment schemes) or recognition of contractual rights (for derivatives).* If property comprising securities or units in managed investment schemes cannot be returned to affected clients, the Scheme could acquire equivalent property in the market or (if such products are unavailable or cannot be obtained without undue market disruption) provide their fair market equivalent.

  Fair market value could be determined as at the date of the defaulting conduct, the date of insolvency (if different) or the date the Scheme operator assesses the claim. The UK scheme gives the scheme operator a discretion to determine the quantification date to enable a fair outcome for investors, depending on the circumstances of each claim.

  Return of property should not extend to "opportunity" or "consequential pecuniary" loss, that is, loss suffered as a result of inability to access one's property (for instance, inability to sell securities due to the improper actions of the intermediary). To cover these losses may significantly increase the cost and assessment requirements of the Scheme. Any detriment is reduced by the Scheme paying immediate compensation, even where there is the possibility of eventual recovery in a liquidation (see further **When compensation should be paid**, post).

- *Compensation for any other amounts that had been, or could be, awarded by an ASIC-approved dispute resolution body or a court.* In consequence, the grounds on which a retail client may lawfully recover against intermediaries in relation to their investments would not differ according to whether the intermediary is or is not solvent. This would ensure that a retail client could receive some return where an intermediary could not pay an amount that had been awarded under a dispute resolution or court procedure because of its subsequent insolvency. It would also apply where the dispute resolution procedure was not used, either because the intermediary was already insolvent or the amount claimed exceeded the jurisdiction of the dispute resolution body.

The combined total amounts payable under both of these general criteria should be subject to an overall cap (see **Capping**, post), given that the Scheme itself, rather than the defaulting intermediary, is providing the compensation.

The Scheme could cover all investment matters affecting retail clients of these intermediaries. For instance, it could cover a fully discretionary securities/derivatives trading account, given that this involves the provision of financial services in relation to investments. Similarly, it should make no difference whether intermediaries hold funds or property for these activities in trust accounts or segregated accounts. By contrast, the Scheme should not cover an outright loan by a client to an intermediary, except where the interest payable is related to the return on investments in an eligible financial market (for instance, securities or derivatives).

Any unauthorised transfers of investments by an insolvent intermediary would come within the Scheme, whether they involve, for instance, broker-sponsored uncertificated holdings or issuer-sponsored uncertificated holdings.

When compensation should be paid

The insolvency of an intermediary does not necessarily mean that its clients are left without any rights of recovery. For instance, the intermediary may have professional indemnity insurance that provides "run-off" cover for events before its insolvency, even where claims are lodged after the insolvency. In some instances, retail clients could eventually recover some or all of their money or property, though payments in particular cases may be contested by the insurer or take a considerable time to resolve.

Nevertheless, the Scheme would best promote investor protection and public confidence by making immediate payments to claimants (within its caps), even where there is some likelihood of an eventual return to those claimants in the insolvency. The Scheme could protect its funds, and avoid claimants "double dipping", through subrogation (see further **Subrogation**, post).

Capping

Minimum thresholds

A minimum threshold below which the Scheme will not pay compensation could reduce the number of small claims, or at least require that all claimants bear some of their own losses. However, unless the minimum was set very low, it could discriminate against those retail investors who have very limited funds to invest and could undermine public confidence in the Scheme.

Upper limits

Existing ASIC-approved dispute resolution procedures may contain jurisdictional caps. For instance, the Financial Industry Complaints Service only deals with disputes up to a stipulated dollar limit. These jurisdictional restrictions do not remove clients' rights, or impose upper limits on recovery. Rather, claimants for a greater amount must seek recovery through the courts, unless both parties agree in writing to the dispute resolution procedure having jurisdiction.

By contrast, caps under the Scheme would impose upper limits on compensation available. These caps serve various functions, namely:

- to help keep the costs of compensation within reasonable bounds, by avoiding unlimited demands on Scheme funds in the event of a significant number of intermediaries becoming insolvent at approximately the same time or the financial failure of a very large intermediary

- to reduce investor expectations that they will necessarily be fully covered in the event of insolvency. This serves to limit any moral hazard problem, particularly where the limitations of the Scheme are widely publicized and understood by the investing public.

Capping could disadvantage those retail clients who have lost substantially more capital than can be recovered under the Scheme. However, caps would better ensure that the Scheme has some funds for all eligible claimants of a failed intermediary without making undue financial demands on solvent intermediaries.

A capping system is a further argument for confining the Scheme to retail clients. A cap, if sufficiently liberal, may ensure that most retail claimants recover all or a significant portion of funds due to them. By contrast, wholesale clients might receive only very limited compensation, given that the funds that they entrust to an intermediary could be much greater than the amounts entrusted by retail clients.

The form of capping

There are various possible forms of capping.

Cap per insolvent intermediary

A cap of this nature would result in the maximum amount that could be paid to a particular client depending on the number of other affected retail clients of that intermediary.

Cap related to the available compensation fund

Under this approach, claims for a particular event could not exceed all or a stipulated proportion of the total available compensation fund at the time that claims are determined. However, this option would only be relevant if the Scheme is funded by an annual, rather than a pay as you go, levy. This cap may result in the fund being depleted by a single event or by a few events. It could also be very inequitable, as the available funds may differ significantly from time to time.

Cap per specified period

This would be a limit on the amount that can be paid by the Scheme in any stipulated period, thereby ensuring that the Scheme could be funded without extraordinary levies. However, this cap could be very arbitrary, as the return to claimants would depend on how many other claims were made in that period. Also, this cap could be determined on a "first come first served" basis (which could be very inequitable) or on a pro rata basis (which would require waiting till the end of the period before making any final payments). Neither option seems practical or equitable.

Cap per client per event

The most equitable option may be a per client per event cap (an allowable claim). That cap could be:

- a dollar (compensation) for dollar (claim) amount up to a certain limit (for instance, $x) per allowable claim and nothing beyond that

- a dollar for dollar amount up to a certain limit plus an additional percentage or series of declining percentages up to further specified limits (for instance, $x plus 50% for any amount claimed between $x and $2x plus 30% for any amount claimed between $2x and $3x, etc) per allowable claim and nothing beyond that. For instance, the UK investor scheme has a limit of £48,000, being 100% of the first £30,000 claimed plus 90% of the next £20,000 claimed

- a fixed percentage of each allowable claim.

Assigning a specific dollar value and/or percentage maximum is beyond the scope of this review, as it may require actuarial estimations of potential compensation costs.

Definition of client for the purpose of capping

Some retail clients may transact only in one name, whereas other clients may transact in various capacities, for instance, in the name of spouses, family trusts or controlled companies. Treating each of these persons or entities as a separate client would give an advantage to those persons who transact in the greatest number of separate capacities.

As indicated in the Appendix to this Paper, most overseas schemes impose a cap per client, regardless of how many accounts they operate or whether the accounts are joint accounts. They aggregate clients' interests in any of their accounts, thereby removing the incentive for investors to set up multiple accounts to obtain maximum compensation. However, investors who operate joint client accounts are treated separately, with the caps applying to each investor.

Time limits for making claims

Without time limits for lodging claims, the Scheme could be exposed to an indefinite long-term liability.

Where the Scheme has provided compensation because the Scheme operator has decided that a particular intermediary is unable to pay (even though there is no formal liquidation), the operator should be entitled to notify all remaining retail clients that they must lodge any claims within a stipulated period, say, three months, from the date of the notice. The Scheme would be entitled to reject any later lodged claims. Alternatively, where an intermediary has gone into formal liquidation, without the Scheme operator making any prior determination of inability to pay, the liquidator could pass any claims by retail clients to the Scheme operator in exercise of the liquidator's usual powers. The time limits on creditors making claims in a liquidation would apply.

Subrogation

Right of subrogation

Subrogation can assist in preserving the Scheme's funds by permitting the Scheme to recover any available funds from an insolvent intermediary. It also ensures that retail clients cannot "double dip" by both claiming against the Scheme and recovering the losses covered by those claims in later separate proceedings against the intermediary.

The general principle in overseas and current Australian schemes is that claimants who choose to accept compensation are required to assign, or are deemed to have assigned, their recovery rights against the intermediary before being paid.

The FSRA contemplates subrogation only to the extent of any compensation payment (s 892F). By contrast, the UK Scheme operator has a discretion to make any compensation payment conditional on the client assigning the whole or any part of the client's rights.

The benefit of limiting subrogation to the extent of any payment is that the client retains recovery rights for any excess. However, giving the Scheme operator a discretion to require full or partial assignment of rights may enable that operator, where appropriate, to more easily take a class action for all the claims of affected retail investors. Nevertheless, if any money received by the Scheme under a subrogated right exceeds the amount paid in compensation to a client, any surplus (less administrative costs) should be paid to that client. Retail clients should not be financially disadvantaged by subrogating their rights in return for compensation. Similarly, the Scheme should not profit from the exercise of subrogation rights.

Actions that prejudice subrogation

The underlying principle should be that any compensation paid to retail clients should, to the maximum extent possible, be recoverable against the assets of the insolvent intermediary. Any action by a claimant that prejudices the subrogation rights of the Scheme against the intermediary should permit the Scheme operator to reject or reduce the claim.

In *SEGC Ltd v Aird* (2001) 38 ACSR 185, the Court held that, in principle, a statutory right of subrogation helped ensure that a compensation scheme had sufficient resources to meet claims. That right might be compromised if the scheme was unable to recover funds through subrogation. The Court said:

> "SEGC's statutory right of subrogation is important as a matter of public policy. It provides a mechanism to obtain an important source of replenishment for the fund which is available for claimants thus fostering the intended boost in and maintenance of confidence in the securities market. It also has the economic impact of keeping levies upon members at as reasonable a level as possible" (para [116]).

However, the then statutory provisions did not clearly reflect that policy. The Court ruled that, under the wording of the then provisions, the SEGC was unable to refuse a claim on the basis that the investors had assigned their rights and remedies to a third person, thereby rendering worthless the SEGC's right of subrogation.

The legislation should make clear that the Scheme operator has a discretion to reject or reduce a claim if the claimant has assigned his or her recovery rights to another person or has otherwise prejudiced the rights of subrogation. The Scheme operator may choose not to exercise this discretion, for instance, if the assignment was directly or indirectly procured by the defaulting intermediary as a condition of a private arrangement to pay some funds to the client.

Powers and duties of the Scheme operator

Prudential powers

The majority of overseas compensation schemes that are analysed in the Appendix to this Paper have no prudential supervisory powers, such as capital adequacy or risk management requirements. Instead, the mandate of these "pay box" schemes is confined to raising and investing funds, and adjudicating and paying claims.

The Canadian Investor Protection Fund is an exception. It has a risk management function, which includes setting capital adequacy, liquidity and reporting standards and regularly auditing members.

The preferable course in Australia would be for the Scheme operator not to have prudential powers, as:

- to include prudential powers already vested in other regulatory bodies may blur lines of accountability and unintentionally leave some aspects of the industry unregulated or, more likely, over-regulated
- to exclude prudential regulation minimises the risk of the Scheme operator appearing to be motivated by a desire to preserve its own supervisory reputation when adjudicating on claims.

Non-prudential powers

The Scheme operator must have sufficient powers to ensure that intermediaries properly contribute to the Scheme according to the funding criteria (see **Funding the Scheme**, post) and that any funds not immediately required for compensation can be invested appropriately.

The Scheme operator should also have access to sufficient information regarding the failed intermediary and its client accounts to make timely payments of compensation, where appropriate. This may require statutory power to obtain information from any relevant person and/or enter into information-sharing agreements with relevant regulators. The Scheme operator may also need qualified privilege and the ability to protect people who disclose information from breach of confidentiality.

In addition, and subject to the power of a clearing house to close out contracts, the Scheme operator should have the power to transfer client accounts of an insolvent intermediary to another intermediary, or close out open positions in derivatives contracts, though exercise of these powers should be co-ordinated with comparable powers of liquidators, financial market operators and regulators. Expeditious transfer may reduce or eliminate any losses suffered by retail clients, though it may only be feasible where the intermediary's accounts are in good order and where no fraud is involved.

Duties

There would need to be external regulation of the powers and duties of the Scheme operator. A useful precedent may be the UK Financial Services Authority September 2001 Rules for the Financial Services Compensation Scheme.

Funding the Scheme

The Scheme should be industry-funded, without any recourse to public revenue. This can be achieved through one or more of the following:

- a transaction levy on investments
- a levy on intermediaries who engage in investments, according to their gross revenue from acting as intermediaries either in all investments or in investments on behalf of their retail clients. The levy could be imposed as a "pay as you go" levy or an annual levy
- insurance
- borrowings.

Transaction levy

The current Australian compensation schemes permit transaction levies, although neither the NGF nor the SFE currently imposes these levies.

Transaction levies have various disadvantages. They:

- could discourage some participation in the market and therefore affect overall liquidity, as market liquidity is very sensitive to any additional direct transaction costs
- are contrary to recent initiatives, such as the abolition of stamp duty on transactions, that are designed to make Australian markets more competitive
- would result in transactions on behalf of wholesale clients funding a scheme directed only at retail clients. To impose this levy only on retail client transactions could be unduly difficult to administer
- may be difficult to apply to non-market products such as unlisted managed investment schemes.

Levy on intermediaries

Imposing a levy on each intermediary would ensure that the entities whose conduct potentially creates the need for compensation bear some of the financial responsibility for it (even though particular intermediaries might pass on some or all of those costs to their clients).

One argument against this levy is that it may result in financially sound intermediaries paying for the conduct of financially failed intermediaries. However, the Scheme may help promote the financial services industry generally, given the confidence the financial safety net may instil in retail investors. In this respect, all intermediaries would benefit from the Scheme.

Gross revenue from all clients or from retail clients only

A levy should be imposed only on revenue generated by intermediaries for investments made on behalf of retail clients. To impose a levy based on total client revenue may result in intermediaries who deal only, or predominantly, with wholesale clients subsidising a scheme directed only at protecting retail clients.

Pay as you go levy or annual levy

Any funding arrangement should give some reassurance to contributors that the funds expected from them within a given period are limited. At the same time, these arrangements should not restrict eligible payments to claimants.

The levy could raise:

- only as much as is needed when intermediaries fail (*pay as you go*), or
- a fixed amount in each period, according to a formula, which can only be altered with, say, government approval (*annual levy*).

Pay as you go. This levy could be imposed when an intermediary becomes or is reasonably expected to become insolvent (and the anticipated claims would unduly drain any reserve). The advantages of this system are:

- it only raises funds that are or are reasonably expected to be required. Insolvencies of intermediaries are relatively infrequent
- it avoids having to decide how to disburse funds raised through a periodic levy that are excess to requirements.

The disadvantages of a pay as you go system are:

- no substantial reserve fund is developed. Levies could potentially be large, even imposing liquidity pressure on contributors, in the event of a series of insolvencies or the insolvency of a major intermediary
- current contributors may fund losses relating to events that occurred in prior periods when they were not in the industry (the equity issue)
- the current contributors may recover their contribution costs from future clients, not those who were covered by the Scheme at the time the levy was imposed.

The Scheme must be able to expeditiously process and pay claims. Under a pay as you go system, this could be achieved by the Scheme being able to impose an immediate minimum levy (with any additional levy component to be calculated later) and/or having adequate borrowing facilities, to deal with matters as they arise.

Annual levy. An annual levy is more predictable, with intermediaries being able to build their contribution into their operating budget for each year.

Excess or deficiency of funds

Depending on the number and size of claims, an annual levy may generate an excess or deficiency of funds.

Excess funds. The Scheme operator should be entitled to reduce or suspend levies when reserves are sufficient to meet likely worst-case possibilities. The Scheme operator should be entitled to invest excess funds to increase the revenue available to the Scheme. To use the excess funds for any other purpose would only be justifiable if it directly or indirectly promoted the investor protection goals of the Scheme.

Deficiency of funds. An annual levy may not suffice if a major intermediary fails, unless the Scheme also has contingency capacity, for instance, through insurance and/or a capacity to borrow funds.

Possible exemption

Should prudentially regulated intermediaries be wholly or partially exempt from any levy requirement to which they would otherwise be subject?

On one view, these intermediaries are much less likely to become insolvent. Without some exemption, or contribution discount, they may be at a competitive disadvantage by having both to incur the higher compliance cost of prudential supervision and also to contribute to the Scheme.

The contrary view is that prudential regulation can substantially reduce, but cannot totally eliminate, the possibility of insolvency.

Insurance

Insurance would permit the Scheme to operate without having all its available funds in a liquid or readily observable form. It could be taken out either:

- to underwrite some or all of the potential costs of the Scheme. If this insurance is available, the Scheme operator could determine the relative cost efficiencies of a levy to pay compensation and a levy to pay for the insurance premium

- to augment the Scheme's resources in the event of an unusually large number of insolvencies and/or the insolvency of a large intermediary.

Borrowings

A borrowing capacity would principally be an adjunct to ensure that the Scheme can always pay eligible claimants their full entitlement without delay, particularly if there is an unexpectedly large level of claims on the Scheme, which exceed its financial reserves.

As indicated in the Appendix to this Paper, comparable UK and US schemes provide for government lines of credit to bridge any deficiency in funds in the event of, say, a major insolvency. This protects retail clients, while at the same time ensuring that the market, rather than the taxpayer, ultimately bears the cost of compensation.

Implications for the Scheme operator

A Scheme operator should be subject to appropriate external control and accountability for funds raised and expended.

Transitional arrangements

Transitional arrangements could deal with any transfer of appropriate funds currently held by the NGF and the SFE to the new Scheme. A substantial transfer could benefit intermediaries by reducing their immediate or foreseeable levies, as well as providing immediately available funds on commencement of the Scheme.

Priority provisions

An additional or alternative reform would be to review the priority provisions of the Corporations Act, as they apply to retail clients in the insolvency of an intermediary. Placing these retail clients higher in the priority order could improve their level of recovery and even in some instances materially reduce or extinguish the amount that would otherwise be payable by the Scheme.

There are some strong arguments, however, against any alteration of the priority rules. Any change could:

- have a major impact on credit arrangements, borrowing costs and international lender confidence in Australian markets
- create considerable inequalities between wholesale and retail clients of an insolvent intermediary if only the latter group were given a higher priority.

Also, retail investors may hold shares or units in wholesale clients, thereby being indirectly disadvantaged by any change to the priority rules.

APPENDIX

INTERNATIONAL INVESTOR COMPENSATION SCHEMES

1. **UNITED KINGDOM – FINANCIAL SERVICES COMPENSATION SCHEME**

2. **CANADA – THE CANADIAN INVESTOR PROTECTION FUND**

3. UNITED STATES – SECURITIES INVESTOR PROTECTION CORPORATION

4. AUSTRALIA – THE NATIONAL GUARANTEE FUND

-THE SFE FIDELITY FUND

FINANCIAL SERVICES COMPENSATION SCHEME - UK		
FEATURE	**DESCRIPTION**	**COMMENT**
HISTORY AND BACKGROUND	The Financial Services Compensation Scheme (FSCS) will draw together 8 separate, existing arrangements when it comes into effect on 1 December 2001. The schemes to be replaced by FSCS include: o The Deposit Protection Scheme o The Building Society Investor Protection Scheme o The Policyholders Protection Scheme o The Friendly Societies Protection Scheme o The Investor Compensation Scheme o The Section 43 Scheme (covering listed money market institutions) o The Personal Investment Authority Indemnity Scheme The new FSCS rules have been developed	**The arrangements summarised in this table relate to the new rules although they are not yet in force** **This table covers the overall structure of FSCS and compensation for the investment sub scheme. Details specifically relating to deposit and insurance compensation have not been included.**

	following a process of industry consultation and consumer research by the Financial Services Authority (FSA) that commenced in 1997 and culminated with the publishing of the latest rules to be finalized in October 2001.	

SCOPE OF THE SCHEME	The Scheme covers 3 broad areas – deposit taking, insurance and investments. Each of these areas will be operated in effect as a sub scheme with separate levy arrangements and some differences in rules. The scheme covers all persons authorized by the FSA. Unauthorized business conducted by authorized firms is not covered. The scheme is also designed to meet UK obligations under the European Directive on Compensation Arrangements and as such includes a number of cross border arrangements eg. It applies to the UK branches of European Economic Area firms where the level of UK compensation is greater than that applying in the EEA home state.	Bringing compensation arrangements together under a single Board and set of rules is designed to achieve a number of policy objectives including: o Providing the investor with a single reference point for compensation. o Consistency of policy direction together with administrative savings o Minimizing difficulties associated with pigeon holing any one organization into a particular compensation sector given the growing diversity of businesses undertaken by many organizations The approach of 3 sub schemes operating under a single umbrella rather than going as far as a single, completely unified scheme has been adopted in recognition of: o The need to tailor differing arrangements for broad product types eg. Claim limits are not applicable to insurance where the prime objective is to ensure continuity of cover in the event of a firm's insolvency

		○ The need to limit the extent of cross subsidization between industries where a firm may be called upon to pay for losses in an unrelated industry from which it derives no benefit.

INVESTMENTS COVERED	Investments – stocks and shares; futures and options; personal pension plans and some long term insurance products such as endowments	.
LOSSES COVERED	**<u>Inability to Pay.</u>** The scheme covers losses due to an authorised firm being unable or unlikely to be able to meet claims against it because of its financial circumstances. Such firms are declared in default by FSCS. Claims may include not only return of property but also claims relating to improper acts or omissions by firms in default. The Scheme does not cover claims for improper behaviour by firms that are still trading and have sufficient resources to meet a claim themselves. . **<u>Retail.</u>** A core philosophy of the Scheme is to protect retail and small business customers not in a position to make informed risk assessments on authorised firms. The following gives a brief overview of the main rules relating to which investors are covered: Investments by other banks, authorised firms, government bodies, superannuation	The default standard is a lesser one than insolvency, which usually has to be declared by a court. This allows greater flexibility and potentially faster claims resolution. However, it imposes a significant workload on the scheme itself and means that it may be difficult to use third party insurance as a means of funding the scheme.

	funds (other than private), large companies and partnerships are excluded. Large companies are defined as meeting any 2 of the following standards – balance sheet or annual turnover in excess of 2.5m Euro or more than 50 employees.	

MAXIMUM CLAIM	Investments. 100% of the first 30,000 and 90% of the next 20,000 to a total of 48,000 pounds. Limits relate to each investor per defaulting firm. Multiple accounts including joint and partnership accounts are aggregated to determine each investor's entitlement. There is no global limit on the total amount payable by the scheme in any given period.	Generally, only 90% of the loss above a certain threshold is payable. This introduces an element of co- insurance whereby the customer shares some of the risk and has some incentive for prudent behaviour. It is planned to publicize compensation arrangements and their limitations more widely to increase the effectiveness of co-insurance.
SUBROGATION	FSCS may make payment of compensation conditional on the claimant assigning the whole or any part of its rights against the defaulting party and/or against any third party to FSCS on such terms as FSCS thinks fit. FSCS must make such recoveries as it reasonably can through the rights so assigned and recoveries exceeding the amount of compensation must be repaid to the claimant.	This ensures the customer is not placed in a better position than it would have been had the default not occurred.
CLAIMS HISTORY	Investments. Since inception of the Investor Compensation Scheme in 1988, 193m pounds has been paid, 24,000 claims processed and 1321 firms declared in default. In the last reporting year, 7,400 new claims were processed, 600 firms were declared in default and 51.6m pounds was paid to 3,762 investors.	The largest number of investment claims has related to losses involving personal pension plans. These often involved negligent advice to leave occupational pension schemes. 86% of last year's claims related to personal pension plans. The majority of the remaining claims were against defaulting stockbrokers

	Last year, 71% of claims were for amounts of less than 30,000 and only 3% involved losses in excess of 48,000 pounds.	for loss of property or money

SOURCE OF FUNDS	The Scheme is funded on a 'pay as you go' basis through a compulsory levy on the relevant group of authorised firms. Pay as you go refers to the fact that no fund is accumulated. Rather levies are raised to cover known or anticipated costs in a year and to provide the necessary liquidity for timely payment of compensation claims. Levies may be phased over each year to avoid the accumulation of large balances by the Scheme. Each year's levies will be adjusted for differences between actual and anticipated costs in prior periods as well as for recoveries from liquidations. An overall ceiling is imposed on the amount of compensation levy that can be imposed in any one year. In the case of the investment sub scheme, the limit is 400m pounds. A levy is raised on all contribution groups to share the basic administration costs of the Scheme. However, each contribution group pays separately for claims and the direct costs of administering claims resulting from defaults by firms in that contribution group.	The pay as you go basis potentially eases the cost burden on scheme members by not raising funds until they are required. It also avoids problems associated with disbursing money that is excess to requirements or when the scheme is wound up. However, it means that no sinking fund is developed to smooth out levy payments over time. Levies in a particular period could potentially be large, especially in the lower risk but higher impact areas of depositors and insurance. The limit on the amount of levy that can be imposed in any one year avoids scheme members being put in the untenable position of having an open ended contingent liability to the Scheme but means that the Scheme may have to borrow to fund large compensation payments and have to repay this debt from future years' levies. There is also some equity issue in the sense that current participants may fund losses relating to prior periods when they were not in the industry. The division of the industry into contribution groups avoids cross subsidy between

SOURCE OF FUNDS (continued)	by firms in that contribution group. For this purpose, each sub-scheme (deposits, insurance and investments) may be further divided into a number of contribution groups according to the nature of business activity. There is no cross subsidisation of claims between the 3 sub schemes. However where there is more than 1 contribution group within a sub-scheme involved in a claim, the Scheme Manager will determine the basis on which the claim will be split between them. Tariffs within each contribution group reflect the level of a firm's activity and are based on an appropriate measure of that activity e.g fund managers are levied on the basis of funds under management and advisors on the basis of commission and fee income. Firms are allocated to the relevant contribution group according to the activity they carry on and may consequently be a member of multiple groups. Each individual firm's total levy will be the aggregate of the individual shares of the levy for each relevant contribution group.	dissimilar industries and allows the tariff basis to be tailored to the nature of the underlying business activity on a more equitable basis. The FSA considered it too difficult and expensive to make a product levy directly on the consumer eg. Some types of service such as advice are not readily leviable. However it is assumed that levies made directly to firms will ultimately be passed on to consumers in the form of higher costs or reduced services. Similarly it was considered difficult in practice to devise levy arrangements where the greatest burden falls on the highest risk participants.

	The levy on the Investor Compensation Scheme last year was 66m pounds.	

GOVERNING LEGISLATION	The Financial Markets Services Act gives FSA an express duty to establish by rules a scheme for compensating consumers. As noted above, the European Directive on Compensation Arrangements also imposes requirements in relation to the EEA.	The FSA states that the industry response to the new scheme has been positive and supportive of the general approach taken. There have been some concerns regarding cross subsidisation eg. Wholesale brokers wanted their own levy group. There was broad agreement on the need to strike a balance between consumer protection and the principle of caveat emptor although consumer groups were opposed to retaining a co – insurance element. Consumer groups also favoured higher payment limits.
GOVERNANCE	Financial Services Compensation Scheme Limited, a company limited by guarantee has been established by FSA as the scheme manager. FSCS Ltd is independent of FSA in its day-to-day decision-making but is accountable to it. For example, FSA approves the financial budget and there will be an MOU in place between the two bodies. Board appointments are made in the public interest and aim to blend industry experience	The objective of a separate management vehicle is to increase efficiency by delegating management responsibility. Having a Board that is seen to be independent of both the authorised firms and the regulator itself is seen as enhancing public confidence.

	with a wider consumer perspective.	

THE CANADIAN INVESTOR PROTECTION FUND	
FEATURE	**DESCRIPTION**
HISTORY AND BACKGROUND	The Canadian Investor Protection Fund (CIPF) is a trust established in 1969 by governing self-regulatory organisations (mainly exchanges) to protect customers in the event of member insolvency.
SCOPE OF THE SCHEME	This scheme is essentially an exchange fund but also covers members of the Investment Dealers Association. There are a number of exchanges operating in Canada covered by this single fund.
OTHER COMPENSATION ARRANGEMENTS	Canada Deposit Insurance Corporation (see below) Canadian Life and Health Insurance Compensation Commission. Property and Casualty Insurance Corporation
LOSSES COVERED	o Only losses resulting from insolvency of a scheme member o Covers only accounts used solely for the purpose of transacting securities or futures business. Accounts must be held directly by a defaulting CIPF member. Accounts of foreign affiliates of a member that are carried by the member are eligible for coverage. o Covers losses of securities, cash balances and certain other property such as segregated insurance funds. The definition of securities is broad and includes stocks, mutual funds, options, futures, bonds, treasury bills etc. o The scheme is not restricted to retail customers and the accounts of intermediaries and agents as well as principal business are covered. However, other CIPF members are not eligible for compensation.

	o Claims are valued at the date of bankruptcy or insolvency of the member without regard to any subsequent market fluctuation. o CIPF may arrange for the orderly transfer or sale of an insolvent members business to another member.

MAXIMUM CLAIM	o The maximum claim was doubled to $1m on 1 September 1999. o A customer's general accounts with the defaulting member are aggregated for the purpose of determining the amount payable. However, certain accounts such as registered retirement plans and accounts held by a person as a custodian etc are treated separately for limit purposes. o Compensation entitlements are reduced to the extent that any deposit insurance entitlements are available. o If the fund is insufficient to meet claims then maximum levies will be raised from members each year and proceeds distributed from time to time until all legal obligations of the CIPF have been discharged.
TIME LIMITS	Claims must be filed within 180 days of bankruptcy or insolvency being declared
SUBROGATION	CIPF may require assignment of customers' claims against the insolvent member
CLAIMS HISTORY	Defined Losses over 31 years of operation have amounted to $25m
SOURCE OF FUNDS	o The Fund is financed by assessments on members of the securities industry made through the sponsoring self-regulatory organisations. It also earns income on its assets. o In addition to funds supplied by member assessments, the scheme has lines of credit from 2 major Canadian banks. o Assessments are levied on members up to a maximum of 1% of aggregate gross revenues of all member firms in that year. o Each member's assessment is determined by its gross revenues and by a risk premium

	based on any capital deficiencies. New members must pay levies at the full historical rate before benefiting from any reduction. o Current Board policy is to set assessments at a rate designed to enable the fund to grow in proportion to industry growth.
SIZE OF FUND	At 1 April 2000 the total fund amounted to $272m comprising investments of $172m and $100m lines of credit. This compares to $600bn customer securities held by members (0.45%).
GOVERNANCE	CIPF has a board of 12 governors comprising 5 representatives of the investing public, 5 representatives of the self-regulatory organisations, the Chairman and CEO.
OTHER	CIPF also participates in the regulatory system and has a co-ordination and risk management function in conjunction with the SRO's. This includes setting capital adequacy; liquidity and reporting standards and regular audits of members together with anticipating financial difficulties and bringing about an orderly wind down or transfer of business where possible.

SECURITIES INVESTOR PROTECTION COPORATION- USA		
FEATURE	**DESCRIPTION**	**COMMENT**
HISTORY AND BACKGROUND	The need for compensation arrangements was perceived following a large number of broker dealer failures in the USA during 1969/70. SIPC was established in 1970 after Congress passed legislation to ‘ provide for customer losses resulting from broker/dealer failure thereby promoting confidence in the nation’s securities markets’.	
SCOPE OF THE SCHEME	SIPC is a compensation scheme for the securities exchanges. With some exceptions all broker/dealers registered with the Securities and Exchange Commission must be members of the scheme. Exclusions include those whose principal business is conducted outside the USA and some firms whose activities are limited to specific, prescribed products or services. SIPC currently has approximately 7,000 members.	This is more like the current Australian position than the UK or Canada with a separate scheme for securities exchanges only that does not cover the futures markets. Amongst other things this reflects the separate regulation of these markets by SEC and CFTC.
OTHER COMPENSATION ARRANGEMENTS IN THE JURISDICTION	Federal Deposit Insurance Corporation National Credit Union insurance programme	Federal Deposit Insurance Corporation was established in 1933 and compensates depositors up to $100,000 in the event of bank

	Chicago Mercantile Exchange (CME) * Board of Trade Clearing Corporation (BOTCC) *	or thrift failure. * A brief outline of compensation arrangements in US futures markets is included at the foot of this table

LOSSES COVERED	- The scheme provides for return of securities and cash lodged with a member firm that fails financially. - Most kinds of security are covered including stocks, notes, bonds, CDs and warrants. Certain kinds of unregistered investment contacts are excluded, as are commodities and futures. - Cash is only covered where it has been deposited for the purpose of purchasing securities or as a result of sales thereof. Cash lodged solely for other purposes e.g earning interest is not covered. In practice all deposits in a securities account are deemed to be for transaction purposes and are covered. - Claims arising out of transactions with a foreign subsidiary of a member firm are ineligible. - SIPC can arrange for transfer of some or all customer accounts to another broker/dealer.	SRO's (exchanges) report to SIPC on members in or approaching financial difficulty. If it considers appropriate, SIPC then applies to the Federal Court to commence a 'customer protection proceeding'. This involves appointment of a liquidator that may be SIPC. SIPC tops up available securities or cash to ensure the return of property to customers up to the maximum limits. In some cases, SIPC may compensate customers directly rather than via a liquidator.

LOSSES COVERED (continued)	○ Where necessary, SIPC will endeavour to purchase securities in the market in an orderly fashion so that they can be returned to customers. If this is not possible the customer will be given cash in lieu based on a market valuation at 'value date'. This is usually the date of publication of proceedings. ○ Exchange traded stock options are covered. However, these are closed out and customers are paid their value on the value date. ○ The only customers excluded from compensation are those connected with	This would generally be done where the member's accounting records are in order and there is no fraud involved.

	compensation are those connected with the defaulting firm (shareholders, directors, brokers etc.). Both retail and wholesale customers are covered.	○ From the clients' perspective, it would generally be preferable to transfer options to another broker where possible rather than to close them out. This is usually attempted by derivatives clearing houses where there is a default involving client positions provided the members accounting records are adequate, no fraud is involved and the cost to the clearing house is not excessive.

MAXIMUM CLAIM	○ $500,000 per customer except that claims for cash are limited to $100,000 per customer. ○ A person who in a single capacity has several different accounts with the same firm would be considered a single customer for the purpose of applying the limits. ○ However, joint accounts, partnerships and trustee arrangements are treated as separate accounts provided they are bona fide and meet the requirements of SIPC rules	○ The $100,000 limit on cash is designed to keep this scheme into line with the Federal Deposit Insurance Scheme. ○ This is a more liberal approach than in the UK and Canada.
TIME LIMIT	SIPC mails claim forms to customers. Claims are only valid if submitted within 6 months of publication of proceedings. Timing of payment depends on the degree of complexity of the proceedings. In straightforward cases where the firm has good records and it is possible to transfer accounts to other brokers this may happen soon after publication of proceedings.	

SOURCE OF FUNDS	SIPC has a fund that at the end of last reporting year stood at $1.22bn. This is funded from member assessments and income from investments in government bonds. The maximum levy that can be made in any one year is 1% of member revenues and the minimum is $150 per member. Since 1996, members have contributed only the minimum $150. SEC has authority to lend SIPC up to $1bn to meet claims if it considers this necessary to maintain confidence in the markets. SIPC must submit a plan for repayment in order to obtain such a loan. If SEC considers that member assessments will not be sufficient for timely repayment then it may impose a market transaction levy. SIPC also has access to bank lines of credit.	

CLAIMS HISTORY	- Since 1970, 291 customer protection proceedings have been initiated including 4 in 2001. Over the past 10 years the average has been 7pa. - Claims have been paid to 440,000 customers. - Only 307 such claims were for cash and securities whose value was greater than the limits of protection afforded by SIPC - SIPC has paid $260m from its fund to customers and $132m in direct claims administration costs. - The largest aggregate payment in relation to a single broker has been $32.5m	Payments by SIPC have been quite small in relation to the total customer funds held by defaulting brokers. SIPC has used available assets held by failed firms totalling more than $3.5bn while needing to pay only $260m from its own fund. This is probably the reason only such a small number of claims have exceeded the maximum limit rather than this being a reflection of the size of individual customer balances with defaulting brokers. The fund is very large in relation to actual claims experience but this may be necessary in relation to possible worst-case scenarios.
GOVERNANCE	The Corporation has a board of seven. The President appoints 5 directors of which 3 represent the securities industry and 2 the general public. One director is an employee of the Department of Treasury and another is an employee of the Federal Reserve Board. SIPC has a staff of 28.	

GOVERNING LEGISLATION	Securities Investor Protection Act 1970. SEC has some regulatory and oversight functions	
OTHER FEATURES OR COMMENTS	SIPC has no risk management or audit functions in relation to members.	

***Futures Exchanges.** There is no legal or regulatory requirement for futures markets to have compensation arrangements in the U.S. CME has a trust fund of $48.8m whilst BOTCC has a fairly recently established fund of $16m. NYMEX has no scheme although the Board has discretion to use exchange funds for compensation purposes.

The CME Board is the trustee of its compensation fund. There is no compulsion to make payments from the fund but the trustees have discretion to compensate customers for losses arising from clearing member failure or inability to pay. Losses must relate to transactions in CME contracts to be eligible. There is no formal cap on individual payments; this is left to the discretion of the trustees. No payments have been made from this fund to date.

THE NATIONAL GUARANTEE FUND		
FEATURE	**DESCRIPTION**	**COMMENT**
HISTORY AND BACKGROUND	The National Guarantee Fund (NGF) was formed through merger of the 6 state exchange fidelity funds when the Australian Stock Exchange (ASX) was formed in 1987.	
SCOPE OF THE SCHEME	The NGF applies to Securities Exchanges or their subsidiaries that are members of the Securities Exchange Guarantee Corporation (SEGC). At present ASX is the sole member of SEGC. Membership of the NGF is compulsory for all ASX Participating Organisations. NGF is both a compensation fund for clients of stockbrokers and a fund that supports guarantees in relation to ASX settlement systems and clearing houses. **This table deals only with the client compensation functions of NGF.**	It is unusual for a fund to support both client compensation and clearing and settlement guarantees. Compensation is concerned with investor protection in relation to their dealings with participants. Clearing guarantees relate to a guarantee of clearing participant contractual obligations. In view of the potentially crucial role of a clearing guarantee in containing systemic risk, it is preferable for this guarantee function to be free of any potential conflict with other funding requirements and directly under the control of the clearing house managing that risk. There is no specification as to how much of the NGF may be used for compensation and how much for clearing guarantee. The whole fund is potentially available for either purpose, although there is a limit on the maximum insolvency compensation paid in respect of any 1 participant. It is conceivable that the fund could be completely depleted by clearing losses leaving no funds available for compensation purposes.
OTHER COMPENSATION ARRANGEMENTS IN THE	SFE Fidelity Fund	

ARRANGEMENTS IN THE JURISDICTION		
LOSSES COVERED	The following types of compensation claim are permissible: ❑ Claims in relation to the completion of sales and purchases of quoted securities entered into by a stockbroker ❑ Compensation for loss that results if a Stockbroker transfers marketable and certain other securities without authority ❑ Compensation for loss that results if a stockbroker wrongly cancels or fails to cancel a certificate for quoted securities. ❑ Compensation for loss that results if a stockbroker becomes insolvent and fails to meet obligations to a person who had previously entrusted property to it.	The need for compensation for wrongful cancellation of a security certificate has largely been removed now that all listed securities are held in electronic form. There is an argument to say that claims for non-completion of transactions and unauthorised transfer against solvent participants would be better handled by dispute resolution or civil proceedings as are other forms of improper behaviour such as unauthorised trading or negligent advice.

MAXIMUM CLAIM	Compensation for losses due to insolvency is limited to 14% of the minimum fund size per participant. On this basis the current limit is \$11.2m. Otherwise there is no limit on either compensation or clearing guarantee payments other than the size of the fund itself.	It is unusual not to have a cap on compensation payments although clearing guarantees are generally not capped other than by the limitation of available resources.

INVESTMENTS COVERED	Insolvency compensation relates to return of property entrusted to a Stockbroker in the course of or in connection with the Stockbroker's business of dealing in securities. There is no entitlement to compensation for money lent to a Stockbroker.	Insolvency claims generally occur where there is a shortfall in the trust account or custodian holdings of the Stockbroker. Claims are normally settled by replacing the property. If this is not possible compensation is paid for the loss.
TIME LIMIT	Claims in relation to completion of transactions must be made within 6 months. SEGC may publish a notice stipulating a time limit for other claims. If no notice is published claims must be made within 6 months of becoming aware of the loss or broker insolvency. SEGC has discretion to allow late claims.	
SOURCE OF FUNDS	The NGF was originally funded by the amalgamation of the 6 state stock exchange fidelity funds. It currently derives income from interest on client trust funds lodged by Participating Organisations with ASX as well as from earnings on its own assets. A transaction levy may be imposed in the event the fund falls below the minimum permissible level. The SEGC also has power to borrow for the	

	purpose of making payments out of the NGF and to obtain fidelity insurance	

SIZE OF FUND	At 30 June 2000 the net assets of NGF were $150.6 m, which compares with $60.4m at the time of its formation. Funds that are surplus to requirements can be paid out of the NGF to the Securities Industry Development Account (SIDA) with Ministerial approval.	
CLAIMS HISTORY	Since the NGF was formed in 1987, a total of $21.3m has been paid in claims of which $13.3m has been recovered. In the period 1994- 2000 only $0.57m has been paid in respect of 40 claims. The majority of claims have involved clients of an insolvent broker	
GOVERNANCE	SEGC is responsible for administering the NGF. SEGC is a company limited by guarantee incorporated to be the trustee of The National Guarantee Fund. The assets of the NGF are the property of SEGC, but must be kept separate from all other property and must be held on trust by the SEGC for the purposes set out in the governing legislation.	

	The SEGC Board is made up of 6 directors.	
GOVERNING LEGISLATION	Part 7.10 of the Corporations Law which will be replaced by Part 7.5 of the Financial Services Reform Bill and accompanying regulation.	

SFE FIDELITY FUND		
FEATURE	**DESCRIPTION**	**COMMENT**
BACKGROUND AND HISTORY	Established by SFE in 1986 in terms of the Futures Law	
PARTICIPANTS	SFE Members	
INVESTMENTS COVERED	Money or other property connected with dealings in futures contracts whether or not those dealings were actually affected; money or property given to a participant by a futures client or where the participant was a trustee	Under FSRB losses are tied to property lodged in connection with a transaction and not to the overall business of dealing as is currently the case
OTHER COMPENSATION ARRANGEMENTS IN THE JURISDICTION	The National Guarantee Fund	
LOSSES COVERED	Pecuniary loss because of defalcation or fraudulent misuse of money or property. The Board has discretion to make payments to a receiver to satisfy the debts of an insolvent member arising from dealings in futures contracts	
MAXIMUM CLAIM	$500,000 per Participant	

TIME LIMIT	Within the limit of any notice published by the Exchange (minimum 3 months). If no such notice is published, within 6 months of the claimant becoming aware of the loss.	
SOURCE OF FUNDS	Transaction Levies and income from fund investments	Levies have not been imposed for some years as the fund is considered adequate.
SIZE OF FUND	$17 million	
CLAIMS HISTORY	There have been no payments from the Fund since 1995. No claims have been paid due to insolvency only.	
GOVERNANCE	SFE Board as Trustee.	
GOVERNING LEGISLATION	Part 8.6 of the Corporations Law which will be replaced by Part 7.5 of the Financial Services Reform Bill and accompanying regulation.	