30 October 2024

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

Dear Committee Secretary & Senior Clerk

Re: Wealth Management Companies

Thank you for the opportunity to provide a submission in response to the Senate Economics References Committee's inquiry into Wealth Management Companies (**Inquiry**).

The Principals' Community is a group of self licenced Australian Financial Services Licensees (**AFSLs**) operating across Australia. There are 128 AFSLs within the Principals' Community with 1,310 advisors servicing approximately 141,000 client groups.

In July of this year, we commissioned our lawyer Jim Bulling a partner at K&L Gates in Melbourne to write to the Minister and set out some of the significant concerns that we had at that time in connection with the introduction of the Compensation Scheme of Last Resort (**CSLR**). A copy of the letter dated 18 July 2024 and the reply from Treasury received on 22 August 2024 are attached at Appendix B.

We set out below a summary of our submission and our related recommendations in relation to terms of reference (c), (d), (i) and (j) of the Inquiry and note that we have not sought to address other than indirectly terms of reference (a), (b), (e), (f), (g) and (h) of the Inquiry. For our detailed submission, please see the Appendix A.

Executive Summary

1. In circumstances where a vertically integrated financial services business is facing a stream of claims from advice clients in respect of a related party product which has failed or underperformed the establishment of the Compensation Scheme of Last Resort (**CSLR**) has created a 'moral hazard'.

2. The existence of the moral hazard is contributing meaningfully to the disproportionate and arbitrary liability which is being imposed on the financial advice sub-sector by way of current and future CSLR levies and needs to be addressed.

3. The circumstances of Dixon Advisory & Superannuation Services Pty Ltd (**Dixon Advisory**) has illustrated the various elements of this moral hazard including the following:

    - faced with an overwhelming stream of former client claims on the advice business the parent company reduced the level of financial support provided to the business and appointed administrators.

- the existence of potential compensation from CSLR to be paid to former client creditors of an advice firm could be expected to influence the Administrator of an insolvent entity in connection with any proposal for a Deed of Company Arrangement or Liquidation. If an administrator and DOCA proponent are aware that claims of former clients will be underwritten by access to CSLR, this has real potential to impact the magnitude of any DOCA contribution sought by an Administrator or offered by a deed proponent to contribute towards the settlement of those claims. This could be expected to result in a consequential reduction in contributions sought and obtained by the Administrator in connection with the administration from other interested parties including the parent entity, shareholders and directors.

- the Administrator of the business has limited resources and responds to AFCA complaints in a formal rather than meaningful manner acknowledging that this class of creditor will likely be eligible to compensation from CSLR. It will not be in the Administrator's interests to expend limited resources in defending unsecured claims against the company when those claims are ultimately underwritten by CSLR

- as a result, the combination of a reduction in contributions from third parties to the administration of the insolvent advice entity together with the lack of engagement by the Administrator in the claims made by former clients of the advice entity leads to potentially a greater number of and higher compensation payments made by CSLR.

- this in turn results in higher contributions made by the advice sub-sector to the funding obligations of CSLR

4. The Australian Financial Complaints Authority (**AFCA**)'s role in determining claims made by former clients of Dixon Advisory has contributed to the moral hazard in a number of ways, including:

    - by applying a narrow approach to apportionment which does not seek to consider other contributors to the losses claimed.

    - the approach of AFCA to assessment of claims against insolvent advice businesses assumes that if appropriate advice had been provided the consumer in each and every case would have invested in a different portfolio of investments.

    - the approach of AFCA to assessing the size of the loss is to adopt a loss of profit basis rather than an actual loss basis.

    - in adopting these positions AFCA have not recognised the lack of resources and the diminished motivation of an Administrator of an insolvent advice company to properly test the assertions advanced by the complainants.

    - such an approach compromises AFCA's commitment to fairness as it does not ensure that there is a full exchange of the relevant information and does not ensure that each party has had an opportunity to address any issues raised.

5. As a result there is a steadily growing stream of AFCA determinations where the adviser is found to be responsible for 100% of the loss and the loss is then assessed on the more generous "loss of profit" basis rather than the "actual loss" basis.

6. This failure to consider apportionment and failure to test the claimants assertions occurs in circumstances where AFCA is delivering what could be in excess of 2700 determinations where the respondent is an Administrator of an insolvent company which has neither the resources nor the motivation to energetically examine the arguments put by the complainant.

7. CSLR was designed to provide redress to consumers when other avenues of compensation have been exhausted ie it is a scheme of last resort. However, when complainants present unsatisfied AFCA determinations to CSLR there is no evidence that CSLR requires them to demonstrate that they have exhausted all other avenues of compensation in particular seeking compensation from concurrent wrongdoers such as product providers.

8. Publicly available information provided by CSLR has indicated that claimants are obtaining compensation payments at or near the maximum (average amount is approximately $100k) amount available and in the case of certain Self Managed Super Funds are obtaining compensation for each member.

9. In addition to the compensation payments, the liabilities of CSLR also include the costs of AFCA and CSLR arising from the respective claims and ASIC's costs in connection with CSLR. Together these additional amounts will represent what is estimated at around 42% of the total of CSLR liabilities for the 2nd levy period and these costs are expected to rise bearing in mind the increased case load for both AFCA and CSLR.

10. The funding responsibility for this disproportionate and arbitrary liability is placed on the limited cohort comprised within the financial advice sub-sector the vast majority of which are small businesses. The liabilities from Dixon Advisory claims alone in the next two years are likely to be in excess of $180 million including the projected costs of AFCA, CSLR and ASIC which is far in excess of what was contemplated when CSLR was being constructed. This is unreasonable and beyond the capacity of the financial advice sub-sector many of whom are small businesses to pay.

11. In the current circumstances without adoption of the recommendations below the administration of AFCA and CSLR and the issue of levies and special levies payable by the financial advice subsector represents the imposition of arbitrary exactions which is not permitted under the Commonwealth's taxing power.

12. Unfortunately the circumstances surrounding Dixon Advisory may not be the only challenge to the future funding obligations of CSLR as the collapse of United Global Capital Pty Ltd is expected to result in a further surge in claims made on CSLR and other similar instances of investment scheme failures will likely emerge in the future.

Recommendations

Having identified the existence of the 'moral hazard' created by the establishment of the CSLR, in order to adequately manage and address such a hazard it is our recommendation that:

<u>General</u>

1. In order to address the arbitrary nature of the levies and special levies payable by the financial advice sub-sector as outlined in this submission including Appendix B the Commonwealth should assume responsibility for funding any liabilities (including costs) resulting from the payment of compensation by CSLR to former clients of Dixon

Advisory over and above the amounts paid or committed by Australia's 10 largest banking and insurance groups.

2. Constraints are placed on the level of costs of AFCA, ASIC and CSLR which are to be funded by the industry levies and that these costs are subject to periodic independent review.

3. Regulation 6 of the Financial Services Compensation Scheme of Last Resort Levy Regulations 2023 be amended to expressly include product providers as a leviable sub-sector for the purpose of the CSLR.

AFCA

4. AFCA review its narrow approach that complaints against financial advice firms are "non-apportionable at law" as it is not bound by strict application of legal principles such as proportionate liability statutes and case law. In particular, in recognition of the liabilities for advisers created by the compensation payable by CSLR, AFCA should consider the contribution to any consumer losses made by the misconduct of others and in particular product providers. The current approach causes manifestly arbitrary and unfair outcomes for financial advisers which contradicts AFCA's paramount duty to do what is fair in all the circumstances.

5. AFCA introduce and consult on an approach to complaint handling and decision-making when hearing matters involving an insolvent respondent that recognises that such parties are less likely to vigorously contest complaints due to the limited resources available and the diminished motivation created by the availability of compensation from CSLR. This is particularly relevant in the circumstances for an insolvent advice company which is part of a vertically integrated financial services group.

6. AFCA review its approach to calculating consumer loss in respect of financial advice claims from comparing the complainant's position as against a hypothetical portfolio (i.e. loss of profit basis) to a more conservative approach such as measuring the loss of invested capital (i.e. actual loss calculation).

CSLR

7. Subject to the response on recommendation 1 above, in respect of the 2nd Levy Period the CSLR Operator, if it has not already done so, urgently commissions a revised claims, fees and costs estimate to determine whether the existing funding is sufficient and if not whether any further funding required of the financial advice sub-sector will result in the levy cap for this period to be exceeded.

8. Subject to the response on recommendation 1 above, in connection with the 3rd Levy Period the CSLR Operator has indicated that it is likely that the financial advice sub-sector levy cap will be exceeded. The Minister in making any determination as to a special levy should consider the circumstances of Dixon Advisory and the issues identified above and consider a special levy for the levy period on the other sub-sectors in recognition of the impacts the levy may have on the sustainability and viability of the financial advice sub-sector and the Australian financial system more broadly and the existence of potential concurrent wrongdoers (eg product providers). In respect of further Levy Periods any consideration and determination of special levies by the Minister should continue to have regard to these factors.

9. The CSLR operator, pursuant to section 1064(h) of the Corporations Act 2001 (Cth) (**Corporations Act**), requires consumers who are yet to attempt to obtain compensation from other sources to pursue other such avenues of compensation. In the case of potential claims against product providers consumers will be expected to lodge such claims with AFCA to ensure that CSLR will act as it was originally intended – and that was a compensation scheme of last resort. Such a requirement is likely to be a much more effective mechanism for dealing with the moral hazard and potential compensation from other sources than the limited practical value of subrogation recovery rights provided to CSLR.

Regards

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Appendix A

1. What is a moral hazard?

1.1 Moral hazard refers to the situation where one party takes excessive risks because they do not have to bear the full consequences of that risk.

1.2 It can most accurately be described as meaning "if you cushion the consequences of bad behaviour, then you encourage that bad behaviour" and it can be created by public policy arrangements including publicly funded compensation schemes as these may discourage individuals or entities from managing certain costly behaviours.

2. How could a moral hazard emerge from the creation of CSLR and the insolvency of a financial advisory firm which is part of a larger financial services group?

2.1 The establishment of the Compensation Scheme of Last Resort (**CSLR**) creates a moral hazard in the following circumstances:

(a) the financial advisory firm (**Advice Co**) is a subsidiary of a parent company (**Parent Co**) which owns more than one advice licensee;

(b) Advice Co has provided to a large group of clients a program of similar advice recommending a small sub-group of products;

(c) one of the products included in that program of advice is issued by a related party (**Product Co**) and has failed or significantly underperformed;

(d) a large or significant number of clients of Advice Co have indicated that they wish to make a complaint to the Australian Financial Complaints Authority (**AFCA**);

(e) Parent Co has assessed that the potential liabilities of Advice Co are significant and are beyond the resources of the company to satisfy in full;

(f) Parent Co refuses (or is unable) to inject additional equity into Advice Co and initiates the appointment of an Administrator to Advice Co;

(g) Parent Co arranges for unaffected clients to transfer to other advice licensees in the group and provides further capital to those licensees;

(h) Advice Co remains a member of AFCA for a period including while Advice Co is in administration;

(i) Clients of Advice Co lodge AFCA complaints;

(j) Administrator of Advice Co has limited resources and responds to AFCA complaints in a formal rather than meaningful manner;

(k) Administrator of Advice Co is aware of the potential for former clients of Advice Co to obtain compensation from CSLR and this may impact the determination of the Administrator to seek funding for the administration from other parties eg parent entities, shareholders and directors;

(l) AFCA finds that Advice Co has breached its statutory obligations and hands down a series of similar decisions in favour of former clients of Advice Co;

(m) AFCA's determinations are impacted by the lack of testing of complainants' arguments by the Administrator;

(n) AFCA determinations cannot be satisfied from the assets of the administration of Advice Co;

(o) Clients of Advice Co subsequently make claims on CSLR;

(p) CSLR pays compensation to a series of former clients of Advice Co and such compensation may be to a greater number of former clients and may be for larger amounts; and

(q) CSLR is obliged to determine the funding required for the compensation payable in respect of unsatisfied AFCA determinations against advisers and to consider appropriate levies for the advice sub-sector and if necessary special levies.

2.2 The appointment of an Administrator to Advice Co as outlined in 2.1(f) is a conventional option for Parent Co as Advice Co is a separate legal entity and the liabilities of Advice Co are its own and are not liabilities of its directors or Parent Co. These are well-established and fundamental concepts derived from case law and the Corporations Act 2001 (Cth) (**Corporations Act**) any proposals to amend these fundamental principles would be unrealistic.

2.3 The Administrator of Advice Co's assessment of the claims of creditors and Parent Co's (and other shareholders and directors) incentive to contribute to the administration of Advice Co are all negatively impacted by the existence of CSLR and the compensation that it provides. As a result the amount available from the Administration of Advice Co to creditors (including its former clients) is less than it might otherwise have been.

2.4 Accordingly, the advice subsector which is comprised of some 15,000 advisers will be exposed to the increased funding obligations required from CSLR which will result from the negative impact on the amount which may otherwise have been available to creditors of Advice Co.

2.5 The creation and ongoing impact of this moral hazard undermines the CSLR's ability to achieve it's objectives of enhancing trust and confidence in the Australian financial system as well as promoting sound and ethical business practices in the Australian financial system.[1]

2.6 Without mechanisms which address and manage some of the impact of this moral hazard, the advice sub-sector will continue to bare the additional financial burden which results.

3. What are the contributors to the moral hazard emerging from the circumstances of Dixon Advisory & Superannuation Services Pty Ltd (Subject to Deed of Company Arrangement) (Dixon Advisory)?

3.1 <u>AFCA's narrow approach to apportionment</u>

(a) AFCA have released a consultation summary and final approach to assessing complaints and apportioning loss in complaints against financial advice firms in

[1] *Constitution,* Compensation Scheme of Last Resort (as at 3 October 2024) cl 3.1.

which they state that claims against financial advisers are "non-apportionable" at law.[2]

(b) AFCA have explained that this narrow approach is required by relevant proportionate liability statutes and case law:

"We confirm that breaches of the best interests duty and failure to give appropriate advice are classified as "non-apportionable" claims under the proportionate liability statutes and that this is consistent with how AFCA has always determined financial advice complaints, where there is more than one financial firm that has contributed to the loss."[3]

(c) This approach to apportionment does not satisfactorily deal with AFCA claims which involve an adviser which provides advice to clients in respect of a related party product which subsequently underperforms or fails as it ignores any potential misconduct on the part of the product provider and the contribution that such misconduct makes to the losses suffered by the clients of the related party adviser firm.

(d) Having reviewed AFCA determinations in respect several recent claims against Dixon Advisory including the "lead decision" against Dixon Advisory (**Lead Decision**),[4] it is noted that AFCA has consistently found that advice provided by the adviser was not appropriate and not in the client's best interests because the proposed investments were not within stated asset allocation parameters and were not adequately diversified.

(e) As a result of AFCA's narrow approach to apportionment, AFCA then does not examine any potential concurrent wrongdoing on the part of the product providers and finds for the complainant and against the adviser for the entirety of the loss.

(f) It is well established that the principle of fairness is a core value of AFCA, required by legislation and underpinning its decision-making approach:

"AFCA is required to decide a complaint based on what is fair in all the circumstances, having regard to factors such as legal principles, good industry practice, codes of practice and previous decisions (which are not binding)".[5]

(g) AFCA have explained that the effect of doing what is fair in all the circumstances is the following:

"The effect of this is to move decisions away from relying strictly on a legal interpretation of the applicable legislation, or the terms and conditions of the

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[2] Australian Financial Complaints Authority, *Consultation Summary and Final Approach* (Web Page) <Consultation summary and final Approach | Australian Financial Complaints Authority (AFCA)>.

[3] Australian Financial Complaints Authority, *Consultation Feedback Report – The AFCA Approach to determining compensation in complaints against Financial Advice Firms where the Responsible Entity of a Managed Investment Scheme has become insolvent,* (Report, January 2024) 5.

[4] *Australian Financial Complaints Authority Case Number 716627* (6 February 2024).

[5] Australian Financial Complaints Authority, *Operational Guidelines to the Rules* (at 1 July 2024) 74.

disputed financial product to a decision that also contemplates fairness… AFCA recognises that legal principles alone do not have the flexibility to allow a claim to be decided on other factors that are particular to a specific situation or that are subjective to a particular Complainant."[6]

(h) Likewise, AFCA further explains that:

"We are not, however, required to strictly apply legal principles. Where we consider that it is fair in all the circumstances to depart from legal principles, we will explain in the Determination our reasons for doing so."[7]

(i) Notwithstanding that claims against financial advisers such as breach of the best interest duty and failure to give appropriate advice may be (see below) classified as "non-apportionable" claims under the proportionate liability statutes and case law, AFCA should have regard to its clear statements and commitment to fairness and should not feel bound by any strict legal interpretation in respect of apportionment.

(j) AFCA should in appropriate circumstances consider any role played by a concurrent wrongdoer in connection with the losses suffered by consumers which in the circumstances of Dixon Advisory were the related party product provider(s). AFCA's overriding principles of fairness prevent it from applying some universal rule that does not apportion liability when determining claims against financial advisers.

(k) In any event, AFCA's assertions that claims against financial advisers are "non-apportionable" at law is not that clear as in the case of *Selig v Wealthsure Pty Ltd* the High Court unanimously confirmed that the proportionate liability regime did apply to section 1041H of the Corporations Act (i.e. misleading and deceptive conduct).[8]

3.2 Where Respondents are insolvent

(a) AFCA states in its determinations of Dixon Advisory cases that each of the parties have completed a "full exchange of the relevant information, and each party has had the opportunity to address any issues raised".[9] However, there is no indication in the small sample of AFCA determinations that we have examined that Dixon Advisory representatives have made any forceful arguments or contested any representations made by the complainants in any meaningful way.

(b) We note that during the period in which the AFCA determinations in respect of Dixon Advisory have been finalised to date Dixon Advisory was under administration and was the subject of a Deed of Company Arrangement (DOCA). The DOCA clearly contemplates that CSLR would be established and

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[6] Ibid.

[7] Ibid.

[8] *Selig v Wealthsure Pty Ltd* [2015] HCA 18.

[9] *Australian Financial Complaints Authority Case Number 716627* (6 February 2024) 13.

that each of the former clients of Dixon Advisory would have an opportunity to make a claim for compensation to CSLR once it had been established.

(c) If an administrator and DOCA proponent are aware that claims of former clients will be underwritten by access to CSLR, this has real potential to impact the magnitude of any DOCA contribution sought by an Administrator or offered by a deed proponent to contribute towards the settlement of those claims. This could be expected to result in a consequential reduction in contributions sought and obtained by the Administrator in connection with the administration from other interested parties including the parent entity, shareholders and directors.

(d) In these circumstances, it seems likely that the Administrators of Dixon Advisory may have taken into account the impact of CSLR and the potential compensation payments which could be made to former clients when negotiating and supporting the terms of the DOCA which included the financial contribution that E&P Financial Group Limited and E&P Operations Pty Limited made to the DOCA.

(e) In addition, the Administrator also has limited resources and will respond to AFCA complaints in a formal rather than meaningful manner acknowledging that this class of creditor will likely be eligible to compensation from CSLR. It is not in the Administrator's interests to expend limited resources in defending unsecured claims against the company when those claims are ultimately underwritten by CSLR.

3.3 Loss is assessed at the more generous "loss of profit" basis

(a) AFCA have released an approach to determining compensation in complaints against financial advice firms where the responsible entity of a managed investment is insolvent which states that:

"Where inappropriate financial advice has been provided, the purpose of the *compensation is to place the complainant in the financial position they would have been in if the financial advice firm had provided appropriate financial advice (i.e. "but for" the failure to provide appropriate advice, what position would the complainant have been in?)."*[10]

(b) AFCA has explained this position as follows:

"To do this, we will compare the consumer's financial position after suffering the adviser's breach of duty with the financial position they could have expected to have been in if the adviser had not breached their duty… For example, where a consumer has received inappropriate advice which caused them to invest in an unsuitable portfolio of investments, we will usually assume that the consumer would instead have invested in a suitable portfolio of investments if they had been advised properly."[11]

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[10] Australian Financial Complaints Authority, *The AFCA approach to determining compensation in complaints against financial advice firms where the responsible entity of a managed investment scheme has become insolvent,* (Report, January 2024) 4.

[11] Australian Financial Complaints Authority, *The AFCA approach to calculating loss in financial advice complaints* (Report, December 2023) 4.

(c) By way of example, the Lead Decision states that:

"to calculate loss, a hypothetical portfolio with the desired characteristics for the complainants' risk profile, objectives, and financial situation should be used for comparative purposes." [12]

(d) As such, when determining compensation in complaints against financial advice firms AFCA calculates the loss on the basis of where the complainants would have been had they received appropriate advice by comparing the complainant's position as against a hypothetical portfolio (i.e. loss of profit basis) rather than a more conservative approach by measuring the loss of invested capital (i.e. actual loss calculation).

(e) In coming to its determinations, AFCA also accepts (in respect of every complainant) that had the correct advice been provided by Dixon Advisory to the complainants they would have chosen to invest in other products. As noted above it does not appear that complainants were examined or tested in this regard.

(f) The combination of AFCA's narrow approach to apportionment of liability and the potential diminished involvement of the Administrators of Dixon Advisory in the AFCA processes means (based on an analysis of a small sample of AFCA determinations to date) that it is likely that each of the AFCA determinations of Dixon Advisory claims (as at 30 June 2024 there were 2,773 complaints against Dixon Advisory since AFCA's inception)[13] will result in 100% of liability for any loss being attributed to the adviser and for that loss in each case to be calculated on the more generous loss of profit basis.

3.4 <u>CSLR does not require an applicant to exhaust all avenues of recovery</u>

(a) The CSLR was designed to provide financial redress to consumers of financial service entities when other avenues of compensation have been exhausted or are no longer available (i.e. as a last resort) and this purpose was emphasised in the Explanatory Memorandum which accompanied the legislation establishing CSLR (**Explanatory Memorandum**).[14]

(b) The CSLR operator has explained that this means the following:

"When making an offer, we first check if you've been paid some of the money from:

(i) the firm

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[12] Ibid at 11,12.

[13] Dixon Advisory & Superannuation Services in voluntary administration | Australian Financial Complaints Authority (afca.org.au) Australian Financial Complaints Authority, *Dixon Advisory & Superannuation Services (Subject to Deed of Company Administration)* (Web Page, 2 September 2024) <Dixon Advisory & Superannuation Services in voluntary administration | Australian Financial Complaints Authority>.

[14] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 1.73.

(ii) liquidator

(iii) third party

(iv) other compensation schemes.

As CSLR is a genuine last-resort compensation scheme, Section 1067 of the Corporations Act (2001) requires us to undertake this check."[15]

(c) Section 1064 of the Corporations Act outlines the requirements for a consumer to be eligible for compensation under the CSLR, including subsection (h) which provides the following obligations for the CSLR operator:

> *"(h) the CSLR operator reasonably believes, having regard to:*
>
> *(i) the relevant entity's financial position (if the relevant entity still exists); or*
>
> *(ii) any other reason;*
>
> *that the person is unlikely to be fully paid the amount in accordance with the determination."*[16]

(d) We also note the CSLR operator's guiding principles which are as follows:

(i) CSLR is committed to strengthening the trust and confidence in the dispute resolution framework for financial services by providing a fair and reasonable compensation service for eligible consumers.

(ii) CSLR recognises the impact of the CSLR Scheme on the relevant Sub-Sectors and seeks to operate a cost-effective, efficient and economical service and to ensure the funds levied on the financial service industry are used appropriately and transparently to promote trust in the Scheme.[17]

(e) In accordance with these guiding principles and the clear legislative intention for CSLR payments to only be accessible after all other avenues for recovery of lost monies has been exhausted, the CSLR operator should ensure that after examining the relevant AFCA determination that the claimants have exhausted all avenues of compensation including in particular compensation from concurrent wrongdoers such as product providers.

(f) We note that section 1069A of the Corporations Act provides the CSLR operator with a right of subrogation to recover some or all of the compensation paid to the consumer for a relevant AFCA determination from the relevant entity against which the determination was made. However, in reality, this mechanism provides limited practical value at best as the relevant entity is very often

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[15] Compensation Scheme of Last Resort, *Claims Process* (Web Page) < Claims process | CSLR>.

[16] *Corporations Act 2001* (Cth) s 1064.

[17] Compensation Scheme of Last Resort, *Policy for Determination of Estimates for First and Second Levy Periods* (Report, April 2024) 6.

insolvent and in any event there has been no indication from the CSLR operator it has have the resources or willingness to pursue this right of recovery.

3.5 CSLR awards include costs of AFCA, CSLR and ASIC

(a) The levy imposed on the financial service industry also includes AFCA's unpaid fees and AFCA's accumulated unpaid fees, the CSLR operator's administrative costs, ASIC's administrative costs and costs to establish and maintain a capital reserve.

(b) The March 2024 Actuarial Report has estimated that the unpaid AFCA fees in relation to the 116 finalised complaints would amount to $1,447,000, with a further $4,717,000 in CSLR costs and $361,000 in ASIC costs for the financial advice sector as a whole for the 2nd levy period. Based on these figures, AFCA, CSLR and ASIC fees would be approximately $4,500 for each finalised Dixon Advisory claim during the second levy period.[18] The costs recovered in respect of each and every claim is yet another burden to be added to the CSLR funding burden for the financial advice sub sector.

(c) Moreover, AFCA, ASIC and CSLR fees and costs amount to what is estimated at around 42% of the total of CSLR liabilities for the 2nd levy period.

(d) Accordingly limitations should be placed on the administrative costs incurred by the CSLR and the level of fees incurred by AFCA and ASIC in relation to the CSLR. These additional costs should also be independently reviewed at regular intervals in order to ensure that the scheme continues to operate a *"cost-effective, efficient and economical service."*[19]

3.6 CSLR has restricted options in respect of striking funding levies

(a) The CSLR levy framework comprises the following funding mechanisms:

(i) an annual levy, which is required to be paid for a levy period by all members of specified sub-sectors;

(ii) a further levy, which is only payable if the amount of annual levy collected is insufficient or is likely to be insufficient to meet the expected claims, fees and costs for the levy period; and

(iii) a special levy, which is a levy that can only be made by a Minister determination in circumstances where the estimated claims, fees and costs for the levy period would exceed the sub-sector levy cap.[20]

(b) Crucial to both the further levy and special levy is the revised claims, fees and costs estimate, which the CSLR operator can commission at any time so long

[18] Finity Consulting Pty Limited, *1st and 2nd Levy Period Initial Estimates*, (Report, 8 March 2024).

[19] Compensation Scheme of Last Resort, *Policy for Determination of Estimates for First and Second Levy Periods* (Report, April 2024) 6.

[20] *Financial Services Compensation Scheme of Last Resort Levy Act 2023* (Cth) s 8.

as it is after the start of a levy period and after re-calculating the initial claims, fees and costs estimates for the levy period and a sub-sector.[21]

3.7 Further levy for the levy period

(a) A further levy for the levy period and the sub-sector may be imposed if:

(i) before a revised claims, fees and costs estimate for that levy period and the sub-sector comes into force, the sub-sector levy cap for that levy period has not been exceeded; and

(ii) the revised claims, fees and costs estimate for the levy period and the sub-sector specifies that a further levy needs to be imposed for the levy period and the sub-sector.[22]

(b) However, a further levy cannot be imposed if it would cause the sub-sector cap for the levy period to be exceeded. [23] Accordingly, it would not be appropriate for a further levy to be imposed on the financial advice sub-sector in these circumstances given the likelihood that the sub-sector levy cap has or would be exceeded.

3.8 Special levies (not just for the primary sub-sector)

(a) The relevant Minister may impose a special levy on more than one sub-sector (not just the primary sub-sector to which the operator's revised estimate relates) for the levy period if:

(i) the CSLR operator notifies the Minister that a revised estimate for the levy period and the sub-sector could cause the sub-sector levy cap for the levy period and the sub-sector to be exceeded (or further exceeded); and

(ii) the Minister decides to impose a special levy for the levy period and one or more sub-sectors.[24]

(b) The Minister may impose a special levy for the levy period on more than one sub-sector if they consider that:

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[21] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 2.51, 2.52; *Financial Services Compensation Scheme of Last Resort Levy (Collection) Act 2023* (Cth) s 10.

[22] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 2.61; *Financial Services Compensation Scheme of Last Resort Levy (Collection) Act 2023* (Cth) s 8.

[23] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 2.63; *Financial Services Compensation Scheme of Last Resort Levy (Collection) Act 2023* (Cth) s 8.

[24] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 2.69; Section 1069H of the Corporations Act; Sections 8 and 9 of the Financial Services Compensation Scheme of Last Resort Levy Act 2023.

(i) it is necessary to do so due to the number and size of compensation payments that are payable;

(ii) that it is the most efficient way of enabling compensation to be paid to those persons in a timely manner; and

(iii) having regard to the impact of the special levy amount on the financial sustainability and viability of the specified sub-sectors and on the financial system more broadly.[25]

(c) As articulated by paragraph 1.112 of the Explanatory Memorandum:

"These guiding principles are intended to ensure that the Minister's power to impose a special levy for the levy period on one or more specified sub-sectors is only exercised where there is a genuine need to do so, and takes into account any adverse impacts the levy may have on the sustainability and viability of the specified sub-sectors and the Australian financial system more broadly. In this way, the Minister's power to impose a special levy is a necessary intervention to deal with circumstances where the annual levy is insufficient (or likely to be insufficient) to meet the demand for compensation payments in a particular levy period."[26]

(d) Paragraph 1.115 of the Explanatory Memorandum explains:

"This ensures that the CSLR is able to operate with sufficient safeguards in an evolving and dynamic financial system, while being responsive to unforeseen events. It is not possible to provide such safeguards in primary law given the need for timely action in response to these events, as they unfold."[27]

(e) In addition, paragraph 2.71 of the Explanatory Memorandum provides:

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

[25] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 2.11, 2.70, 2.80, 2.81; *Corporations Act 2001* (Cth) s 1069H(5).

[26] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 1.112.

[27] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 1.115.

needed to make compensation payments to consumers as quickly as possible."[28]

3.9 Estimate of future levies arising from Dixon Advisory and other claims

(a) Based on the assumptions included in the March 2024 Actuarial Review the potential liabilities arising from Dixon Advisory claims for the third and fourth levy period and beyond is likely to be in excess of $180 million including the projected costs from AFCA, CSLR and ASIC (which for example constitute approximately 42% of the total liability for the 2nd levy period) and this does not include potential liabilities in respect of compensation claims arising from the collapse of United Global Capital Pty Ltd.

(b) Such amounts are beyond the capacity of the advice sub-sector to pay and the Minister, if they have not already done so, should urgently commission a revised claims, fees and costs estimate with the expectation that this would reveal an exceeded sub-sector cap and hence require the Minister to be notified that a special levy ought to be imposed.

3.10 Imposition of levies in practice is proving to be arbitrary

(a) As outlined in Appendix B, the CSLR levy imposes a financial burden on one group (the sub-sectors) for the benefit of another group (consumers who experienced financial misconduct) and these features often indicate that a law should be categorised as a tax.[29] We further note that a taxation law does not need to be expressly state that its aim is to raise revenue.

(b) The nature of the taxing power can be described in various ways, with the term "taxation" said to cover every conceivable exaction which it is possible for a government to make, whether under the name of a tax, or under such names as rates, assessments, duties, imposts. While the CSLR has been designed as a compensation scheme, it contains many of the attributes which are relevant to the definition of a tax, including the imposition of levies.

(c) The Commonwealth's taxing power does not however permit the imposition of arbitrary exactions.[30] In the context of CSLR, the impact of the 2nd levy, and potentially further levies, places disproportionate and arbitrary liability on Licensees as evidenced from a consideration of a number of key factors including the issues identified above together with the following:

(i) The maintenance in the 2023 Bill of the 7 September 2022 cutoff date specified as part of the introduction of the lapsed 2022 Bill.

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[28] Explanatory Memorandum, *Financial Services Compensation Scheme of Last Resort Levy Bill 2022*, 2.71.

[29] *Luton v Lessels* [2002] 210 CLR 333 [60].

[30] *MacCormick v Federal Commissioner of Taxation* (1984) 158 CLR 622, 640 (Gibbs CJ, Wilson, Deane and Dawson JJ).

(ii) The sustained encouragement provided by ASIC from August 2022 for clients of Dixon Advisory to make AFCA claims before Dixon Advisory's membership of AFCA ceases.

(iii) The postponement of the cessation of Dixon Advisory's membership of AFCA to 30 June 2024 the decision taken during 2023 to significantly increase in the scope of AFCA fees which could be recovered from the scheme even when it was apparent that the previously estimated liabilities for the scheme did not take account of the black swan event created by the Dixon Advisory claims.

(iv) the ambiguous references including in the March 2023 second reading speech to liability for the "backlog" of claims to be borne by Australia's 10 largest banking and insurance groups bearing in mind the retention of the 7 September 2022 cutoff date.

(v) The consideration given by Government to Australia's 10 largest banking and insurance groups at the expense of Licensees contained within the last-minute amendment to the liability for the backlog of Dixon Advisory claims made in the Minister's Determination in March 2024.

(d) Should a court assess such arbitrariness, it may look at whether those subject to the levies, who ordered their affairs legitimately in accordance with law prior to the CSLR legislation, are now treated differently because of the new legislation. This assessment is based on equity being one of the three ‘dominant’ tests for a tax system identified by the Taxation Review Committee in 1975.

(e) As a result, the enactment of the Financial Services Compensation Scheme of Last Resort Levy Act 2023 in the circumstances described above is beyond the constitutional powers of the Commonwealth to impose taxes.

(f) In order to address the arbitrary nature of the CSLR levies payable by the financial advice sub-sector, the Commonwealth should assume responsibility for funding any liabilities (including costs) resulting from the payment of compensation by CSLR to former clients of Dixon Advisory over and above the amounts paid or committed by Australia's 10 largest banking and insurance groups.

We would be happy to discuss any questions you have in respect of the matters raised in our submission.

K&L GATES

18 July 2024

Partner: Jim Bulling
[redacted]
T [redacted]

By email: Stephen.Jones.MP@aph.gov.au

The Hon Stephen Jones MP
Assistant Treasurer and Minister for Financial Services
House of Representatives
Parliament House
Canberra ACT 2600

Without prejudice

Dear Minister

Compensation Scheme of Last Resort

We write to you on behalf of our client the Principals' Community (**Principals**), a group of self-licenced Australian Financial Services Licensees (**Licensees**), operating across Australia. There are 122 AFSLs within the community, with 1220 advisors servicing approximately 129,000 client groups.

We have been instructed by Principals on behalf of its Licensee members to put in writing its dissatisfaction with the terms of the Compensation Scheme of Last Resort (**CSLR**) and in particular the proposed Levy (**Levy**) to be issued to and payable by Licensees that provide personal financial product advice to retail clients.

Accordingly, we are instructed as follows:

- that any payment by a Licensee of a Levy in respect of the second levy period issued by the Australian Securities and Investments Commission (**ASIC**) is paid under protest and without prejudice to the rights of any Licensee; and

- that you as Minister amend the terms of the Determination issued in March 2024 (or such other appropriate executive act) such that liability for the claims made by clients of Dixon Advisory and lodged with the Australian Financial Complaints Authority (**AFCA**) during the period from 7 September 2022 to 30 June 2024 (inclusive) are not borne by the financial advice sub-sector and failing this;

- that K&L Gates consider preparing a statement of claim which will amongst other things seek orders:

    » returning to Licensees in whole or in part the amount of Levies paid under protest;

    » preventing (temporarily or permanently) the issue by ASIC of notices to pay levies to Licensees; and

» appropriate declarations and orders in relation to the validity of the Levies.

These instructions have followed an examination by our client of the following circumstances:

1. Legislative background to introduction of levies

1.1 On 28 October 2021, the Government introduced the *Financial Services Compensation Scheme of Last Resort Levy Bill 2021*. Treasurer Josh Frydenberg also stated in a press release that the Government would fund the establishment of the CSLR and contribute to scheme costs in the first year. Section 17 of the draft legislation proposed the following levy caps:

» An overall scheme levy cap of $250 million. The Government intended this to be the total amount that could be levied in a levy period on all persons across all subsectors.

» A sub-sector levy cap of $10 million. The Government intended this to be the levy amount that may be imposed for any levy period on all persons in a particular sub-sector. However, the section permitted the sub-sector levy cap to be increased in the regulations and allowed it to be exceeded after a relevant Ministerial determination.

This Bill was not debated and lapsed at the dissolution of the 46th Parliament ahead of the 2022 federal election.

1.2 On 8 September 2022, the Government introduced the *Financial Services Compensation Scheme of Last Resort Levy Bill 2022* as outlined in the Explanatory Memorandum. Section 17 of the draft legislation proposed the following levy caps:

» an overall scheme levy cap of $250 million; and

» a sub-sector levy cap of $20 million.

1.3 On 25 October 2022, Treasurer, Jim Chalmers handed down the October Budget. The 2022/2023 October Budget Paper (No 1.) states:

> "Subject to the passage of legislation, the CSLR will be funded by the Government in the first year of operation, and thereafter by levies on the financial services sector."

1.4 On 8 March 2023, the Explanatory Memorandum that accompanied the Treasury Laws Amendment (Financial Services Compensation Scheme of Last Resort) Bill 2023 stated:

> "The first levy period begins on the day specified in a determination made by the Minister and ends on 30 June 2024. The costs for the first levy period are to be funded by the Commonwealth. For all subsequent levy periods, the levy amount for the levy period is required to be paid by parts of the financial services industry."

The following day, the 2022 Bill was discharged from the Senate Notice Paper.

1.5 On 9 May 2023, Treasurer, Jim Chalmers, handed down the 2023/2024 Budget. The 2023/2024 Budget Paper (No 1.) states:

> "Subject to the passage of legislation, the CSLR will be funded by the Government in the first financial year of operation, and thereafter by levies on the financial services sector."

1.6 On 14 March 2024, just three weeks prior to the commencement of the scheme, estimates for the first and second levy periods were released. The estimates were as follows:

» The 1st levy period was estimated to cost $4.8 million and was to be funded by the Australian Government.

- The 1st levy period estimate was published in the Corporations (Financial Services Compensation Scheme of Last Resort—First Levy Period Cost Estimates) Determination 2024.

» The 2nd levy period was estimated to cost $24.1 million and was to be funded by financial subsectors, including Licensees who were liable for $18.562 million.

- The 2nd levy period estimate was published in the Financial Services Compensation Scheme of Last Resort Levy (Collection) (Initial Cost Estimates for 2024-25 Levy Period) Determination 2024.

1.7 On 2 April 2024, the CSLR scheme came into effect, and the 1st levy period commenced.

1.8 On 14 May 2024, Treasurer, Jim Chalmers, handed down the 2024/2025 Budget. The 2024/2025 Budget Paper (No 1.) states:

> "Legislation to establish the CSLR was passed on 22 June 2023. The CSLR will be funded by the Government in the first levy period, which ends 30 June 2024. Thereafter, liabilities under the CSLR will transfer to the financial services sector and will be funded by levies on the sector."

1.9 On 1 July 2024, the 2nd levy period commenced.

2. Provision for additional funding and a black swan event

2.1 A black swan event was canvassed in the early drafting of the CSLR legislation. Such an event was anticipated in the *Compensation Scheme of Last Resort: Proposal Paper* published by the Treasury in July 2021.

» Regarding the $250 million annual scheme cap, the paper stated:

> "The amount is considered high enough to fund claims for compensation in circumstances where there has been a large or 'black swan' event relating to a financial firm providing an in-scope financial product or service. Additionally, the amount is also considered low enough to support the sustainability of the scheme by limiting its potential yearly impact on leviable financial firms throughout the life of the scheme".

» The paper also proposed a special levy (**Special Levy**) be included in the legislation.

» The Treasury proposed that the Special Levy was for funding a substantial shortfall where annual levies provided for a particular subsector are insufficient to meet subsector outlays during a claim year and other secondary mechanisms are not available (for example, the capital reserve has been substantially depleted) or are not appropriate (for example, outlays in other reserves have been substantially depleted) or are not appropriate (for example, outlays in other subsectors are also expected to exceed levies provided).

» The Treasury intended the Special Levy to be:

> "a key funding mechanism to fund the payment of a large body of eligible claims made against the scheme following a large failure or 'black swan' event. In circumstances where a large firm has failed and AFCA complaints lodged against the failed firm would be eligible for compensation under the scheme, the special levy would facilitate the collection of additional funds to meet any subsequent CSLR claims".

2.2 Such an event also appeared to have been contemplated when the *Financial Services Compensation Scheme of Last Resort Levy Bill 2021* was introduced on 28 October 2021. Clause 3.9 of the Explanatory Memorandum accompanying the bill, stated the following:

> "In some circumstances, the flow of expected compensation claims may cause the CSLR operator to revise its estimate of the amounts needed in a levy period Where a revised estimate exceeds a sub-sector levy cap, the Minister may determine to levy amounts against a sub-sector in excess of a sub-sector levy cap or levy amounts against a sub-sector that was not liable for the initial annual levy".

2.3 However by 2023 the potential of such a black swan event was no longer hypothetical as evidenced by documents from 2023 released under the *Freedom of Information Act 1982 (Cth)* (**2023 Briefing documents**) which highlighted that:

» AFCA had experienced a large increase in complaints made against Dixon Advisory;

» the initial estimate of the one-off levy was significantly understated; and

» the government anticipated increased implementation and maintenance costs of the scheme.

2.4 At the introduction of the Bill in March 2023 the second reading speech made on 8 March 2023 included a statement that:

> "As I will set out in introducing the Financial Services Compensation Scheme of Last Resort Levy Bill 2023, a back log of complaints that have been lodged with the Australian Financial Complaints Authority (**AFCA**) and that are expected to be eligible to claim on the CSLR will be funded through a one-off levy on Australia's 10 largest banking and insurance groups."

> "Since the original bill was introduced by the previous government, a material event occurred in the market that significantly increased the amount that would need to be paid out of that one-off levy."

2.5 The only material response at that time to the increasing liabilities from the complaints against Dixon Advisory was the inclusion in the Bill of a deferred collection of the one-off levy from one payment to a series of payments over 3 years. However there was no reference in the accompanying materials to the 2023 Bill that the collection of levies in respect of the liabilities for the complaints against Dixon Advisory would come from other than Australia's 10 largest banking and insurance groups.

2.6 The 2023 Briefing documents also contained a document headed "Q&As" which included the following statements:

» Why doesn't the scheme help the victims of past failures?

> "It would not be appropriate nor desirable that current industry participants be required to contribute to pay for compensation arising from determinations against former industry participants."

» What is behind the significant increase in the backlog of accumulated complaints since the last time the CSLR Bills were introduced into Parliament?

> "The collapse of Dixon Advisory in January 2022 has resulted in a significant increase in the number of complaints received by AFCA. These complaints form part of the backlog of accumulated complaints on pause with AFCA."
>
> "The CSLR will address the backlog of accumulated complaints which are within scope of the scheme."

» How many complaints make up the backlog of accumulated complaints?

> "As at 1 February 2023, the backlog is comprised of a total of 1,836 complaints, of which 1,638 relate to Dixon Advisory."
>
> "The backlog is comprised of in-scope complaints provided to AFCA by 7 September 2022, which is the day before the CSLR Bills were last introduced into Parliament."

» How much will it cost to address the backlog of accumulated complaints?

> "…The CSLR operator will be responsible for determining an estimate of the funding required to address the costs relating to the backlog. The value of the estimate will be collected via a one-off levy to be imposed onto the ten largest banks and insurers (excluding health insurers)."
>
> "The CSLR operator will work closely with AFCA to understand the nature and value of the backlog as part of finalising its estimate for the one-off levy."

» Why are the ten-largest banks and insurers groups required to address the backlog of accumulated complaints?

> "The one-off levy is being imposed onto financial services firms who are best placed to contribute to the costs of the backlog of accumulated complaints. This appropriately reduces any risks that addressing the backlog would have to the financial system more broadly. It is also

> appropriate that these firms contribute to the backlog given their engagement in misconduct as uncovered by the Financial Services Royal Commission."
>
> "…The CSLR levying framework balances the provision of compensation to claimants with the impact that the scheme may have on firms required to contribute to its costs."

» How will the CSLR respond if there are more large failures?

> "The CSLR operator will have the ability to seek further funding during a levy period from in-scope sub-sectors up to the scheme levy cap limit of $20 million per sub-sector."
>
> "Where further funding would result in a scheme levy cap being exceeded, Ministerial involvement will be required to impose a levy. In these circumstances, the Minister may determine that a special levy is to be imposed onto the sub-sector responsible for the funding shortfall, or alternatively be spread across various sub-sectors, including those that are outside the scope of the CSLR."

2.7 At the time of introducing the Bill in 2023, the Government knew about the backlog of accumulated complaints following the collapse of Dixon Advisory as well as other circumstances:

» Ministerial Submission MS22-001739 highlights that complaints against Dixon Advisory will expose the financial advice sector to the possibility of higher estimated costs in future years leading to a sensitivity in the sub-sector.

» A letter from Financial Services Minister Stephen Jones to Prime Minister Anthony Albanese referring to Ministerial Submission MS23-000379, references the fact that the one-off levy payers and representatives raised concerns and were consulted with regarding the proposed design and operation of the one-off levy. This ultimately led to the progression of eight targeted changes to the CSLR levy design.

2.8 In addition to this acknowledgement that the black swan event had already occurred, the 2023 Ministerial submission to the Assistant Treasurer released as part of the 2023 Briefing documents contained a proposal to expand the scope of AFCA fees which could be recovered from the scheme by enabling AFCA to recover its total costs associated with assessing complaints including the user charge in addition to the complaint fee.

2.9 The effect of this change to the proposed 2023 Bill was to add yet further potential liabilities to the scheme arising from the complaints against Dixon Advisory and add to the funding burden of the scheme to be borne by industry. This increase in scheme costs was not set out in the 2023 Bill's Explanatory Memorandum.

2.10 When the 2022 Bill was introduced in September of that year the backlog cut-off date was selected as 7 September 2022 the day before the introduction of the Bill. Notwithstanding that the 2022 Bill was withdrawn and replaced by the March 2023 Bill the cutoff date was not changed with the result that Dixon Advisory claims to AFCA continued during the period after 7 September 2022. The maintenance of the September 2022 cutoff date ultimately had the effect of arbitrarily allocating

responsibility for funding the scheme in respect of those claims being allocated to the financial advice sector including the Licensees.

2.11 On 3 August 2022, ASIC published a media release urging former Dixon Advisory clients to lodge AFCA complaints if they believe they have suffered a loss due to misconduct. At this time, ASIC also indicated that they will be writing to the former clients, highlighting that complaints should be lodged as soon as possible:

> "As complaints may only be made against firms who are members of AFCA, complaints against Dixon Advisory should be made as soon as possible. If Dixon Advisory's AFCA membership ceases then no further complaints can be accepted."

2.12 On 5 April 2023, ASIC cancelled Dixon Advisory's AFSL but required the company to remain an AFCA member until at least 8 April 2024. On 28 May 2024, AFCA advised the administrators of Dixon Advisory of its intention to expel Dixon Advisory as an AFCA member. On 21 June 2024, AFCA issued a notice of expulsion to take effect on and from 30 June 2024.

2.13 There were 1,638 complaints relating to Dixon Advisory by 1 February 2023 as highlighted in 2.6. As at 30 June 2024, AFCA had registered a total of 2,773 complaints against Dixon Advisory.

2.14 As discussed above there are several references in the Q&A document and the 2023 Briefing documents which suggest that responsibility for funding the backlog should rest with Australia's 10 largest banking and insurance groups.

Despite this it was not until March 2024 and the publication of the Minister's Determination that the industry got the first indication that a significant proportion of the liability for all the claims arising from Dixon Advisory was not going to be met by Australia's 10 largest banking and insurance groups but was going to be imposed on Licensees the vast majority of which are small businesses which are not "best placed to contribute to the backlog of accumulated complaints" (See above in Q&As).

3. Arbitrary impact

3.1 The CSLR levy imposes a financial burden on one group (the sub-sectors) for the benefit of another group (consumers who experienced financial misconduct) and these features often indicate that a law should be categorised as a tax.[1] We further note that a taxation law does not need to be expressly state that its aim is to raise revenue.

3.2 The nature of the taxing power can be described in various ways, with the term "taxation" said to cover every conceivable exaction which it is possible for a government to make, whether under the name of a tax, or under such names as rates, assessments, duties, imposts. While the CSLR has been designed as a compensation scheme, it contains many of the attributes which are relevant to the definition of a tax, including the imposition of levies.

[1] *Luton v Lessels* [2002] 210 CLR 333 [60].

The Commonwealth's taxing power does not however permit the imposition of arbitrary exactions.[2] In the context of CSLR, the impact of the 2nd levy, and potentially further levies, places disproportionate and arbitrary liability on Licensees as evidenced from a consideration of a number of key factors including the following:

» The maintenance in the 2023 Bill of the 7 September 2022 cutoff date specified as part of the introduction of the lapsed 2022 Bill

» The sustained encouragement provided by ASIC from August 2022 for clients of Dixon Advisory to make AFCA claims before Dixon Advisory's membership of AFCA ceases

» The postponement of the cessation of Dixon Advisory's membership of AFCA to 30 June 2024

» the decision taken during 2023 to significantly increase in the scope of AFCA fees which could be recovered from the scheme even when it was apparent that the previously estimated liabilities for the scheme did not take account of the black swan event created by the Dixon Advisory claims

» the ambiguous references including in the March 2023 second reading speech to liability for the "backlog" of claims to be borne by Australia's 10 largest banking and insurance groups bearing in mind the retention of the 7 September 2022 cutoff date

» The consideration given by Government to Australia's 10 largest banking and insurance groups at the expense of Licensees contained within the last-minute amendment to the liability for the backlog of Dixon Advisory claims made in the Minister's Determination in March 2024

3.3 Should a court assess such arbitrariness, it may look at whether those subject to the levies, who ordered their affairs legitimately in accordance with law prior to the CSLR legislation, are now treated differently because of the new legislation. This assessment is based on equity being one of the three 'dominant' tests for a tax system identified by the Taxation Review Committee in 1975.

3.4 As a result, the enactment of the Levy Act in the circumstances described above is beyond the constitutional powers of the Commonwealth to impose taxes.

4. Ministerial discretion

4.1 Licensees may be unreasonably burdened by the Minister's broad, discretionary powers under s 1069H of the *Corporations Act 2001* (Cth).

4.2 Under s 1069H, the Minister has the power to make a determination imposing a Special Levy to cover a shortfall for a levy period.

4.3 Concern about whether the legislative regime sufficiently constrains the Minister's discretion, was vocalised in early deliberations of the CSLR legislation, with industry bodies, such as the Australian Banking Association (**ABA**) questioning the scope of

[2] *MacCormick v Federal Commissioner of Taxation* (1984) 158 CLR 622, 640 (Gibbs CJ, Wilson, Deane and Dawson JJ).

Ministerial power. In its submission to an inquiry by the Senate Economics Legislation Committee in October 2022 (**Inquiry**), the ABA stated:

> "the special levy mechanism must be subject to full parliamentary approval (ie not enacted through a legislative instrument)".

4.4 Further criticism was evidenced in the report in relation to the Inquiry, with Coalition Senators noting that Minister's considerable powers to issue special levies would give the Minister "very broad discretion to determine further levies upon industry to fund the scheme". The Coalition Senators expressed concerns that it was unclear how this discretion was "sufficiently constrained" in the legislation and recommended that constraints on the Minister's discretion be included in legislation and not left to regulations.

4.5 Despite the opposition, the Minister's power to impose a Special Levy by way of determination, remains.

4.6 As a result, sub-sector groups, including Licensees, risk an unreasonable burden of being liable to cover a shortfall for a levy period under Special Levies, and remain financially at the behest of sweeping Ministerial discretion.

Summary

We are aware that many Licensees and not just those which our client represents are concerned about the circumstances surrounding the issue of the Levies including participating in a petition to inform the Government that:

- the retrospective and arbitrary application of the Levies contradicts fairness principles and Government promises,
- and the reduction of the Government's previously stated commitment to cover the scheme's initial costs for twelve months.

Our instructions are to seek a satisfactory response to the key demand made by our client that you as Minister amend the terms of the Determination issued in March 2024 (or some other appropriate executive action) such that liability for the claims made by clients of Dixon Advisory and lodged with AFCA during the period from 7 September 2022 to 30 June 2024 (inclusive) are not arbitrarily allocated to the financial advice sub-sector including Licensees.

If such a response is not received by Wednesday 31 July 2024 our instructions are to assist with next steps which may include further engagement with industry and proceeding to prepare the statement of claim referred to earlier in our letter without further notice to you.

Yours faithfully

[redacted]

Jim Bulling
Partner

Australian Government
The Treasury

Ref: MC24-011333

Mr Jim Bulling
Partner
K&L Gates
[redacted]

Dear Mr Bulling

Thank you for your correspondence of 18 July 2024 on behalf of your clients to the Hon Stephen Jones MP, Assistant Treasurer and Minister for Financial Services, concerning the Compensation Scheme of Last Resort (CSLR) funding arrangements.

The CSLR facilitates compensation of up to $150,000 to eligible consumers who have an unpaid determination from the Australian Financial Complaints Authority (AFCA) relating to personal financial advice, credit intermediation, securities dealing and/or credit provision. The CSLR started operating from 2 April 2024 and has started compensating eligible consumers.

Establishing the CSLR was recommended by the 2017 Supplementary Final Report of the Review of the financial system external dispute resolution and complaints framework (Ramsay Review) and the February 2019 Final Report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission).

The CSLR is industry-funded in line with the recommendations of the Ramsay Review. This feature was consistent with the legislation introduced by the previous government. The annual CSLR levy is imposed on in-scope subsectors, that is, those financial service subsectors whose products and services are covered by the scheme.

The CSLR was designed to be financially sustainable for in-scope subsectors. To ensure this financial sustainability, there is a $20 million subsector cap and a $250 million scheme cap on industry levies imposed each financial year. The Minister must be notified if the $20 million industry subsector cap is expected to be exceeded and relies on the scheme operator's estimates in this regard. The Minister may then determine that compensation payments be paid to consumers in instalments over time and/or that a special levy be issued. A special levy may be issued to in-scope and/or out-of-scope subsectors.
Any determination made by the Minister that leads to a special levy being imposed must meet the criteria set out in section 1069H of the *Corporations Act 2001*.

The CSLR legislative framework permits the Minister to intervene only if a subsector cap is exceeded, which has not occurred to date. The Government will continue to monitor the implementation and operation of the scheme to ensure it is meeting its policy intent.

Importantly, the determinations referred to in paragraph 1.6 of your letter (and described as the "Determination issued in March 2024") were estimates made by the CSLR operator. The Minister has no power to revoke or amend those instruments.

Once again, thank you for taking the time to write.

Yours sincerely

Chris Lyon
Acting Assistant Secretary
Financial System Division