

## Chapter 3

### The impact on Trio Capital investors and the issue of compensation

3.1 This chapter considers the effect that the collapse of Trio Capital has had on investors. The committee received several submissions and took evidence from various people who were defrauded of their superannuation through their investment in Trio Capital. An important part of this inquiry is to acknowledge their story and their hardship.

3.2 The terms of reference for this inquiry direct the committee to address the issue of access to compensation and insurance for Trio Capital investors, including in circumstances of fraud. This second part of this chapter details the current compensation regimes in Australia for investors. It then considers the adequacy of compensation available to those caught by the Trio Capital collapse.

#### **The impact on investors**

3.3 This inquiry has gathered considerable evidence detailing the catastrophic effect that the collapse of Trio Capital has had on many investors. Forty-four of the 74 public submissions received by the committee were from individual submitters (or couples) who had been defrauded of their superannuation. The committee also held a community forum in Thirroul, north of Wollongong, to take evidence in public session from 11 Trio Capital investors.

#### ***The financial impact***

3.4 The extent of the financial losses to investors was considerable. Mr Shayne and Mrs Tracey Bonnie from Wollongong told the committee that:

Our position at the moment is that Astarra has pretty much wiped us out. We had \$169,000 stolen from our self-managed super fund and another \$57,000 stolen from money that we invested using a margin loan. Before we started all this, our previous super balance was about \$300,000, which was 20 years of investing the maximum amount that we could the whole time. After the \$169,000 was stolen we had to start selling off our superannuation portfolio at a loss to pay margin calls, of which we had had none up to that stage. We are now left with a balance of \$60,000 in super. We also had to contribute extra cash into our super to prop up the other investments; otherwise, we would have lost them as well. So any extra contributions are gone now; we cannot access them until we reach retirement age.<sup>1</sup>

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1 Mr Shayne Bonnie, *Committee Hansard*, 6 September 2011, p. 7.

3.5 Mr Nicholas McGowan also made a significant investment in the Astarra Strategic Fund (ASF). He told the committee that he and his wife had investments worth 'about \$185,000 in super and nonsuper' in the Fund. He added:

Due to the recent falls in the share market, we have been forced to sell our remaining investments outside of super in Australian shares, as our loan-to-value ratio imposed by the margin lender exceeded the maximum allowed. I have taken the time to calculate that we would not have had to sell shares if Astarra had not been a fraud. I had a conservative LVR [loan to value ratio] of 40 per cent when Astarra froze, and this would now be at 51 per cent if Astarra still had legitimate value. This is still about 30 per cent away from a margin call, even after the dramatic falls in the market we have seen in recent months.<sup>2</sup>

3.6 Mr Ian Hogg, a pharmacist, lost close to \$300,000 in the Trio collapse. As a result:

...I will be working for the next five years approximately six days a week. Today it is costing me more money to come here because I am working as a relieving pharmacist. ...I lost \$298,000, and there were other moneys which have obviously decreased because of the global financial crisis. So I am down to about 35 per cent of what I had and, as I say, I am 60.<sup>3</sup>

3.7 Another submitter, who asked for their name to be withheld, is also faced with significant losses:

The collapse of Trio caused a write off of the value of our Astarra Strategic Fund "assets" leaving us with high loan to value ratios close to the buffer zone. With the recent downturn in the share market we were forced to first inject cash, then sell off a good portion of other shares to avoid a margin call.

This has left us with an investment portfolio with a value about one quarter of where we started in 2007, and still with an outstanding loan amount to pay off. Our superannuation value has also been reduced to the level that it was about 20 years ago when we were new investors.<sup>4</sup>

3.8 Mr Ross Tarrant, who was responsible for advising many of those who lost money in the Trio Capital collapse, listed in his submission 25 people (by occupation and by relationship to Mr Tarrant) who had lost sums ranging from \$602 183 to a little over \$5000.<sup>5</sup>

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2 Mr Nicholas McGowan, *Committee Hansard*, 6 September 2011, p. 18.

3 Mr Ian Hogg, *Committee Hansard*, 6 September 2011, p. 23.

4 Name withheld, *Submission 56*, pp 1–2.

5 Mr Ross Tarrant, *Submission 35*, p. 2.

3.9 Mr Ron Thornton, the President of the Association of ARP Unitholders, noted that his 74 members incurred losses of approximately \$58 million. He told the committee:

All of the unit holders have self-managed superannuation funds and their loss represents the majority of their superannuation savings. This represents a financial wipe-out in their later years when they are unable to return to the workforce to fund their retirement, as 91 per cent are over 60 years of age and 68 per cent are over 65 years of age. Two years have elapsed since the collapse of Trio and unit holders have received no response with respect to where their superannuation investment is and how much, if any, remains.<sup>6</sup>

### **The emotional impact**

3.10 In addition to significant financial losses, the Trio collapse also exacted a heavy social and psychological toll on investors. Mr Tarrant recognised the impact on these people:

As advisor to 220 people who trusted me with their lifetime savings and future financial well being, they have now lost approximately \$25 million as a direct result of my financial advice by including ASF into our client portfolios. The hardship, frustration, despair and heartache endured by these people is not able to be captured by words on pieces of paper or understood by those unaffected. The sleepless nights, worry, nervousness, disbelief and anger are the side effects to the reality that financial security has been lost, assets sold, and replaced with uncertainty and angst. Some people have taken on a second job, others are working overtime, some have extended retirement for another 5 or 10 years, some have returned to work and others are not as fortunate.

All have had their mental and/or physical health affected with at least one suffering a heart attack. Most have had marital problems with at least one couple divorcing. As a self employed Accountant and Financial Advisor for in excess of 23 years, the people my advice has affected include people from all walks of life, some known to me personally, all known to me professionally.<sup>7</sup>

3.11 Mr Shayne and Mrs Tracey Bonnie explained the impact on them and their family:

We haven't lost our house yet but we are living from month to month. Every couple of months we are reviewing our budget to see whether we can continue or need to sell up. We downsized our car and family holidays have

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6 Mr Ron Thornton, President, Association of ARP Unitholders Inc., *Committee Hansard*, 30 August 2011, p. 18.

7 Mr Ross Tarrant, *Submission 35*, p. 1.

been scrapped. It is very hard explaining to our kids why life has changed so much.<sup>8</sup>

3.12 Mr John Telford, a Wollongong-based investor who suffered substantial financial losses, criticised the light sentence for Mr Richard given the significant financial and emotional toll on investors:

I certainly paid more personally for Richard's crime and my punishment continues my lifetime. Richard was given a deal, no one offered me a deal. I could not attend the court case on Friday 12 August, so I do not know what unfolded in the proceedings. The newspaper coverage made no mention about a defense standing-up for the victims of this horrendous crime. ASIC and APRA did not present the suffering and anxiety Richard's devastating crime caused to the elderly retirees - some too old or infirm to reenter the work force.<sup>9</sup>

3.13 Mr Telford added:

Had ASIC shown its own findings to the court, such as;

'It found some investors suffered "catastrophic loss", which meant "their life will never be the same". Some felt prolonged anger, uncertainty, worry and depression. Several lost their homes and many had been seriously ill since the loss. Many went without food on occasion and avoided heating or cooling their home. Those who were ashamed to tell others of their plight had isolated themselves from friends and family, and the impact had created long-lasting marital strain.'

such evidence could have illustrated the harm Richard's fraudulent crime caused and continues to have its impact.<sup>10</sup>

3.14 Another investor wrote:

I have not alluded to the emotional stress that this whole affair has had on me, even writing this submission has got me all worked up again. I know that I am not as badly off as some people who have lost a lot more than I did, I can't begin to understand how traumatised they must be.<sup>11</sup>

3.15 As did submission 55 from a couple who asked that their name be withheld:

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8 Mr Shayne and Mrs Tracey Bonnie, *Submission 1, Supplementary Submission B*, p. 2.

9 Mr John Telford, *Submission 66*, pp 2–3.

10 Mr John Telford, *Submission 66*, p. 3. The quote within this quote is sourced by Mr Telford as: 'Investors gutted by financial losses—study by Nicole Hasham', May 30 2011 <http://www.illawarramercury.com.au/news/local/news/general/investors-gutted-by-financial-lossesstudy/2178201.aspx>

11 Name withheld, *Submission 3*, p. 5.

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All of the drama has caused considerable mental anguish with sleepless nights and bickering which was worst [sic] than any financial loss.<sup>12</sup>

3.16 The fact that so many of those who made submissions asked for their name to be withheld, or for their submission to be confidential, is another indicator of the embarrassment and anguish that can accompany financial losses. The committee also acknowledges that the stated motivation for investing in the Trio Capital funds was to prepare adequately for retirement, and not to be a burden on future governments through drawing a pension.

3.17 Yet another individual who asked that their name be withheld put it this way:

We, like so many other investors in SMSF's, were trying to get our superannuation and investments to the point where we could live off them in retirement comfortably with no reliance on a Government pension. We believed that we were doing everything correctly as desired by the Government to provide ourselves with a fully self funded future in retirement. Our retirement will now be reliant on the pension.<sup>13</sup>

### ***Committee view***

3.18 The committee is extremely troubled by the impact that the Trio fraud has had on a substantial group of Australians. The evidence presented above highlights the considerable emotional and financial burden on individuals and families. In many cases, Australians who had saved for many years to provide for their retirement were defrauded of the entire balance of their retirement savings, which in some cases exceeded \$1 million. It is particularly saddening that this fraud appears to have fallen heavily on many people who had made particular and conscientious efforts over many years to accumulate and manage savings so that they would not be required to rely on the pension.

### **Compensation arrangements for investors affected by fraud or misconduct**

3.19 The second part of this chapter deals with the matter of compensation. There are two statutory compensation schemes that are relevant to investors affected by the collapse of Trio Capital. The first, a compensation scheme under the *Corporations Act 2001*, exists for consumers who receive a financial product or service from Australian Financial Services Licensees (AFSLs). The second, established under the *Superannuation Industry (Supervision) Act 1993*, operates for superannuation funds regulated by the Australian Prudential Regulation Authority (APRA).

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12 Name withheld, *Submission 55*, p. 1.

13 Name withheld, *Submission 56*, p. 2.

### *Compensation under the Corporations Act 2001*

3.20 Division 3 of Chapter 7 of the *Corporations Act 2001* (the Corporations Act) prescribes the obligations and duties AFSLs must observe. The obligations and duties of AFSLs, prescribed by Division 3 of Chapter 7 of the Corporations Act, include an obligation to 'do all things necessary to ensure that the financial services covered by the license are provided efficiently, honestly and fairly'<sup>14</sup> and require that the AFSL 'have a dispute resolution system' in place.<sup>15</sup>

3.21 In addition to those duties, Section 912B of the Corporations Act requires that AFSLs providing services to retail clients must have arrangements to compensate clients for any damage suffered due to a breach of a Chapter 7 obligation.<sup>16</sup> Subsections 912B(2)–912B(4) state that the compensation arrangements must:

(2)(a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind—satisfy those requirements; or (b) be approved in writing by ASIC.

(3) Before approving arrangements under paragraph (2)(b), ASIC must have regard to: (a) the financial services covered by the licence; and (b) whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue; and (c) any other matters that are prescribed by regulations made for the purposes of this paragraph.

(4) Regulations made for the purposes of paragraph (3)(c) may, in particular, prescribe additional details in relation to the matters to which ASIC must have regard under paragraphs (3)(a) and (b).<sup>17</sup>

3.22 In its *Regulatory Guide 126: Compensation and insurance arrangements for AFS licensees*, the Australian Securities and Investments Commission (ASIC) states that the requirement to have sufficient compensation arrangements in place is met by an AFSL having adequate professional indemnity insurance:

If you provide financial services to retail clients, you must have arrangements for compensating those clients for breaches of Ch 7 of the Corporations Act. The primary way to comply with this obligation is to have professional indemnity (PI) insurance cover.<sup>18</sup>

3.23 The Guide also states that ASIC considers that adequate professional indemnity insurance:

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14 Paragraph 912A(1)(a), *Corporations Act 2001*.

15 Paragraph 912A(g), *Corporations Act 2001*.

16 Section 912B, Chapter 7, *Corporations Act 2001*.

17 *Corporations Act 2001*, section 912B

18 Australian Securities and Investments Commission, *Regulatory Guideline 126 – Compensation and insurance arrangements for AFS licensees*, December 2010, p. 4.

...depends on all the facts and circumstances—including the nature, scale and complexity of your business, and your other financial resources.<sup>19</sup>

3.24 The process for determining adequacy however is one of self-assessment:

It is up to you to determine what is adequate PI insurance to meet your obligations under s912B and obtain such PI insurance...

...[W]e will not 'approve' your PI insurance arrangements.

You should also have a process of ongoing assessment of your PI insurance to ensure it remains adequate.<sup>20</sup>

### ***Compensation under the Superannuation Industry (Supervision) Act 1993***

3.25 The *Superannuation Industry (Supervision) Act 1993* (SIS Act) also requires that superannuation funds make provision to make some measure of compensation for investors who incur losses as a result of the fraud or misconduct of a trustee(s).<sup>21</sup> Part 23 of the SIS Act makes provision for financial assistance for certain superannuation entities that have suffered loss as a result of fraudulent conduct or theft.<sup>22</sup> Section 229 prescribes that:

(1) If:

(a) a fund suffers an eligible loss after the commencement of this Part; and

(aa) at the time it suffers the loss, the fund is:

(ii) a regulated superannuation fund (other than a self-managed superannuation fund); or

(iii) an approved deposit fund; and

(b) the loss has caused substantial diminution of the fund leading to difficulties in the payment of benefits; a trustee of the fund may apply to the Minister for a grant of financial assistance for the fund.

(2) The application must be in writing and be accompanied by such information as the Minister determines.

(3) To avoid doubt, an application may be made under this section by a trustee of a self-managed superannuation fund as long as the fund met the requirements in subsection (1) at the time the fund suffered the loss to which the application relates.<sup>23</sup>

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19 Australian Securities and Investments Commission, *Regulatory Guideline 126 – Compensation and insurance arrangements for AFS licensees*, p. 15.

20 Australian Securities and Investments Commission, *Regulatory Guideline 126 – Compensation and insurance arrangements for AFS licensees*, December 2010, p. 15.

21 Section 227, Division 1, Part 23, *Superannuation Industry (Supervision) Act 1993*.

22 Section 227, Division 1, Part 23, *Superannuation Industry (Supervision) Act 1993*.

23 Section 229, *Superannuation Industry (Supervision) Act 1993*

3.26 Where an application is made, and the Minister is satisfied that the fund has suffered an eligible loss, the Minister can determine whether the public interest requires that a grant of assistance be made to the fund. In those situations where a grant of assistance is made the compensation paid can be recovered by the use of a levy on APRA-regulated superannuation funds and approved deposit funds.<sup>24</sup>

3.27 Part 23 of the SIS Act specifically excludes self managed superannuation funds (SMSFs) from this regime. Accordingly, SMSFs ability to claim compensation for fraud is limited to the provisions in the Corporations Act. As a result, SMSFs would be required to pursue compensation for fraud via a professional indemnity insurance claim against the AFSL, on whose advice they relied.

3.28 In its submission, Treasury explained the rationale for excluding SMSFs from Part 23 of the SIS Act:

The financial assistance scheme under Part 23 of the SIS Act does not apply to SMSF trustees, on the basis that they have direct control over their superannuation savings. Consequently, SMSFs are not required to pay any financial assistance levy imposed on APRA-regulated superannuation funds when compensation is paid under the scheme.

Excluded funds, the precursors of SMSFs, were specifically excluded from the financial assistance scheme when it was first introduced with the SIS legislation in 1993.

The scheme has been reviewed several times over the past two decades. The reviews consistently confirmed the exclusion of SMSFs from the scheme.<sup>25</sup>

3.29 These reviews included the Financial System Inquiry (Wallis Inquiry) in 1997, the Review into the operation of Part 23 of the SIS Act in 2003 and the Super System Review in 2010.<sup>26</sup>

3.30 In case of Trio Capital, investors who suffered loss through an APRA regulated fund were eligible for compensation pursuant to Part 23 of the SIS Act. Those who had invested in Trio through an SMSF on the advice of an AFSL are limited to pursuing compensation through their financial advisor's professional indemnity insurance.

### **The government's compensation of Trio investors**

3.31 On 13 April 2011, the federal government announced that based on the application of the acting trustee of the four Trio funds, ACT Super Management Pty Ltd, the government would be providing approximately \$55 million in financial

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24 Treasury, *Submission 28*, p. 1.

25 Treasury, *Submission 28*, p. 2.

26 Treasury, *Submission 28*, p. 2.

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assistance for Trio investors who had invested via an APRA-regulated fund. The then Minister for Financial Services and Superannuation, the Hon. Bill Shorten MP, stated:

Over 5,000 victims of fraud from the collapse of Trio Capital Limited (Trio), will be compensated for their loss, following a Government decision announced today...

Investors in APRA regulated funds deserve to be compensated by the Government when they lose their investments through fraud or other malfeasance by super fund trustees. I'm very pleased to be able to offer Trio investors this compensation...

The assistance to the trustee, granted under Part 23 of the Superannuation Industry (Supervision) Act 1993, is for the Astarra Superannuation Plan, the Astarra Personal Pension Plan, the My Retirement Plan and the Employers Federation of NSW Superannuation Plan (the superannuation funds).

Based on the application from the Australian Prudential Regulation Authority (APRA)-appointed acting trustee of the four superannuation funds, ACT Super Management Pty Limited, and advice from APRA, I am satisfied the four superannuation funds have suffered an eligible loss under the Act and the public interest requires a grant of financial assistance be made...

The grant of financial assistance will be recovered by way of a levy on regulated superannuation funds under the Superannuation (Financial Assistance Funding) Levy Act 1993.<sup>27</sup>

3.32 It is important to note that the compensation arrangements do not prevent a loss being incurred. The effect of this compensation arrangement is to reallocate the losses suffered to APRA-regulated superannuation fund investors. Rather than the losses falling narrowly on a small group of investors, it is spread across all Australians who have invested in an APRA-regulated superannuation fund.

3.33 The committee believes that these arrangements are appropriate in a compulsory tax preferred retirement savings system, where individuals rely on prudentially regulated and licensed trustees. The mechanism is accepted by the superannuation funds, results in minimal cost to the totality of savings and is critical to maintaining ongoing confidence in the financial system.

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27 The Hon. Bill Shorten, Assistant Treasurer, Minister for Financial Services and Superannuation, 'Financial Assistance to Trio's Superannuation Fund Investors', Media Release No. 51, 13 April 2011, <http://assistant.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2011/051.htm&pageID=003&min=brs&Year=&DocType=0>, (accessed 8 November 2011).

### *The limits of the government's compensation package*

3.34 Chapter 2 noted ASIC's estimate that there were around 690 direct investors in the ASF not eligible for financial assistance. Of these, around 285 are SMSFs and the balance either individuals, corporations or trusts.

3.35 The government's decision under provisions of the SIS Act to restrict compensation to investors in APRA-regulated funds involved in the Trio collapse received criticism from submitters to the inquiry. The basic argument is that investors in SMSFs should be covered for loss due to fraud or misconduct by an AFSL, in the same way that investors in APRA-regulated superannuation funds are currently protected.

3.36 As noted, SMSF investors in Trio acting on the advice of an AFSL are limited to pursuing compensation through their financial advisor's professional indemnity insurance. The avenue is provided for under the Corporations Act, although even here, they are restrictions. As the Association of Superannuation Funds of Australia noted in its submission:

The current compensation arrangements under Chapter 7 of the Corporations Act 2001 (Corporations Act) are predicated upon the licensed financial services or product provider (financial provider) having in place adequate and sufficient professional indemnity insurance (PII) to assist in meeting a compensation claim. There will be circumstances, however, where PII is inadequate, or unavailable, to respond to a claim for compensation.<sup>28</sup>

### *The Richard St. John Review*

3.37 A government-commissioned review of the need for, and costs and benefits of, a statutory compensation scheme has noted that there will be circumstances where professional indemnity insurance is insufficient and will not provide victims of fraud any compensation. In an April 2011 consultation paper, the review's principal, Mr Richard St. John, stated:

There are some limits to the effectiveness of professional indemnity insurance as a mechanism for compensating retail clients who suffer a loss as a result of a licensee's misconduct. As stated in RG 126, ASIC intends to administer the professional indemnity insurance framework to reduce the risk, as far as possible, that retail clients go uncompensated where a licensee has insufficient financial resources to meet claims by retail clients. However, professional indemnity insurance is an imperfect mechanism to achieve this protection for consumers.

In evidence to the PJC [Parliamentary Joint Committee on Corporations and Financial Services] Inquiry, ICA [Insurance Council of Australia] noted that it is problematic to try to make a commercial product into a

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28 The Association of Superannuation Funds of Australia Limited, *Submission 31*, p. 2.

compensation mechanism. ASIC is also of the view that there are inherent limitations on the effectiveness of professional indemnity insurance as a compensation mechanism for retail investors who suffer loss.

The obligation to meet a successful compensation claim rests with the licensee in question. If, for whatever reason, the licensee's professional indemnity insurance policy does not respond to such a claim, the licensee is left to meet the liability from its own resources.<sup>29</sup>

3.38 Similarly, the review also noted that there will be 'various circumstances' where a claim against a professional indemnity insurance policy cannot be paid, whether in full or in part, to the claimant. In these circumstances, the licensee remains liable to meet that claim from its own resources. It continued:

The claimant is then exposed to the risk that the licensee will not be in a position to meet the claim owing to the closure of its business, insolvency or other reason. Where the licensee has become insolvent in the absence of insurance, the claimant's only avenue for compensation is through the liquidation process. As an unsecured creditor the claimant is unlikely to recover all, if any, of its claim.

The essence of the problem for a claimant, where a licensee is not able to look to an insurer to cover a claim, is that the licensee may be insolvent (or become insolvent as a result of claims against it), is no longer trading or in a position to provide compensation.<sup>30</sup>

3.39 It is precisely this issue that has frustrated many SMSF investors in Trio seeking compensation, leading to calls for these investors to be covered under Part 23 of the SIS Act. Mr Paul Cohen, who lost his life savings in the collapse, commented on ASIC's admission that the professional indemnity insurance regime for AFSLs is inadequate:

We have no compensation because we are a SMSF which is grossly unfair. In relation to my circumstances (the ARP Growth Fund) the total amount of Indemnity Insurance available in the various related entities policies is so small ASIC are not in a position to sue. This is puzzling as how could ASIC have complied with their own guidelines on adequate insurance for financial services licensees?<sup>31</sup>

3.40 In similar vein, Mr Roy and Mrs Barbara Fowler observed:

...ASIC has said that in the ARP collapse the total amount of Indemnity Insurance available in the various directors and entities policies (excluding Auditors we would think) is so small it is not a proposition to sue. If that is

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29 Richard St. John, *Review of compensation arrangements for consumers of financial services*, April 2011, pp 52–53.

30 Richard St. John, *Review of compensation arrangements for consumers of financial services*, April 2011, p. 56.

31 Mr Paul Cohen, *Submission 20*, p. 3.

so, then how could ASIC have complied with its own regulatory guidelines on adequate insurance for financial services licensees?<sup>32</sup>

3.41 Mr Cohen also queried the consistency of ASIC's approach to retrieving funds, contrasting its response to retrieving funds from Trio's auditors with its response to other financial collapses. He wrote:

In cases such as the Westpoint collapse ASIC it seems, took action against auditors to get investors funds and we ask that ASIC take this action against the auditors in the case of The ARP Growth Fund as well.

We are the victims of what is described as the biggest superannuation scam in Australia's history but unlike Westpoint and/or Storm there is no compensation for us. We relied on the regulator to ensure regulatory compliance and under ASIC's nose the TRIO situation was allowed to occur.<sup>33</sup>

3.42 A submitter, who asked that their name be withheld, queried why compensation arrangements for SMSF investors in Trio should be any different from Trio investors through APRA-regulated superannuation funds:

It is illogical and unfair to not compensate retail or SMSF investors...when the same Trio Capital and associate entities that were entrusted with retail investors funds were also involved with the superannuation investments that were compensated, and supposedly licensed and regulated by the Government bodies mentioned above. In other words, if the conduct of Trio Capital and its (mis)management of superannuation funds was such that it was necessary to compensate \$55 million of those funds, then ordinary retail investors' funds that Trio Capital also (mis)managed should also be due compensation.<sup>34</sup>

3.43 With reference to SMSF investors in Trio, the submitter underlined a qualitative distinction between market based losses and losses through fraud and theft. In the latter case, which was the Trio experience, the submitter cited strong grounds for compensation:

Considering that we investors were doing the right thing by providing for our own future retirement needs, and the probability of fraud, also supports the need for Government compensation of all investors. The Astarra investment was not supposed to be a quick rich scheme; it was recommended by a Wollongong financial planner as a way of diversifying into international shares, with the argument that such diversification into international shares was necessary because the Australian share market was only 2% of the world's market. Astarra was advised to be a fund that invested in international shares, and hence a reasonable assumption was

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32 Mr and Mrs Roy and Barbara Fowler, *Submission 17*, p. 3.

33 Mr Paul Cohen, *Submission 20*, p. 3.

34 Name withheld, *Submission 18*, p. 2.

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that a complete loss of the funds would be dependent upon all the international companies in the fund going bust. However, it would seem that no such foreign share purchasing occurred; rather, the funds were likely stolen. It is understood that investing involves market volatility, but the occurrence of loss through fraud is an entirely different matter.<sup>35</sup>

3.44 As Chapter 6 of this report emphasises, many SMSF investors were given advice by financial planners to invest in Trio. Many, if not most of these investors were unaware of the limits on compensation in the event of fraud. In any event, their investment primarily reflected the advice of their adviser, and their basic confidence in Australia's financial regulatory framework. The following extract from one submission gives a good sense of this mindset:

We took their advice [financial planners], understanding the risks of our growth investment strategy, but confident in the knowledge that our loan to value ratio was not high and we had many years to retirement to weather any market downturns.

My wife and I both rolled over our industry regulated superannuation funds into our SMSF. At the time we were not aware that SMSF's were not covered by fraud compensation, but if we were we would probably have proceeded anyway as we thought it inconceivable that any regulated and approved investment, managed fund, or licensed managers or directors in the Australian financial system could be fraudulent.<sup>36</sup>

### **A last resort compensation scheme**

3.45 Following the collapse of several large financial service providers, most notably Storm Financial in 2009, this committee undertook an inquiry into financial products and services in Australia. During the course of its investigations, the committee formed the view that current compensation arrangements are inadequate, and that more work was needed to determine whether a statutory compensation regime would be cost effective and desirable in Australia. Accordingly, the committee recommended that the government investigate the costs and benefits of different models of a statutory last resort compensation fund for investors.<sup>37</sup>

3.46 As part of the Future of Financial Advice (FoFA) reforms announced on 26 April 2010, the government commissioned Mr Richard St. John to undertake a review to consider the need for, and costs and benefits of, a statutory scheme to compensate consumers of financial services. In announcing the review, the government identified that it was to be initiated in response to this committee's November 2009 recommendation. The final Richard St. John report was released in

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35 Name withheld, *Submission 18*, pp 2–4.

36 Name withheld, *Submission 56*, pp 1–2.

37 Parliamentary Joint Committee on Corporations and Financial Services, *Inquiry into financial products and services in Australia*, November 2009, p. 146.

May 2012. The concluding part of this chapter presents some of the findings of that report and the committee's view on these findings

3.47 The SMSF Professionals' Association of Australia (SPAA) noted that the issue of financial loss due to misconduct or insolvency is not limited to superannuation, but is a broader issue affecting all investors. It argued that currently:

In SPAA's view there is inadequate protection against misconduct and insolvency of an Australian Financial Services (AFS) licensee for those who invest through SMSFs as opposed to other investment vehicles. SMSF members are mostly retail investors who are less able to absorb investment losses when compared with larger funds of the kind regulated by APRA. SMSF members are similar and aligned to ordinary investors in the marketplace and are not similar to APRA regulated fund members.

SPAA acknowledges that SMSF investors make a consensual decision to make their own investment decisions but in SPAA's view that should not result in SMSF members being left to fend for themselves if they lose money due to the misconduct or insolvency of an AFS licensee.<sup>38</sup>

3.48 The Association of Superannuation Funds of Australia (ASFA) supported the introduction of a last resort compensation scheme.

Given that, within the financial sector, the consumer is the least able to withstand the loss caused by a financial provider's breach or misconduct, it would seem apposite to introduce a statutory scheme of last resort to compensate consumers for such losses, in circumstances where the financial provider is insolvent and therefore unable to pay the compensation.

ASFA submits that such a scheme should be statutory and should be utilised only as a scheme of "last resort", where the financial provider whose breach or misconduct caused the loss, which gave rise to the successful claim for compensation, is insolvent.<sup>39</sup>

3.49 SPAA also supported the introduction of a last resort compensation scheme. It argued that this is needed to improve consumer trust and confidence in the financial services industry.<sup>40</sup>

3.50 Other organisations were critical of a last resort compensation scheme. The Financial Planning Association, for example, stated that it is:

...unable to support a proposal for a last resort compensation scheme until the regulatory and compensation framework is able to ensure that each participant in the financial services industry has responsibility and financial

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38 SMSF Professionals' Association of Australia, *Submission 44*, p. 3.

39 The Association of Superannuation Funds of Australia Limited, *Submission 31*, p. 6.

40 SMSF Professionals' Association of Australia, *Submission 44*, p. 3.

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accountability to the end consumer for their role in ensuring the effective and ethical delivery of products and services.<sup>41</sup>

3.51 According to the FPA, this change requires a 'complete overhaul' of the existing financial services compensation regime, which attaches responsibility for compensation to the parties with a causal link to the fault.<sup>42</sup>

3.52 CPA Australia also raised concerns with the appropriateness of a last resort compensation scheme given dilemmas with equitably compensating investors and the potential for 'moral hazard':

The difficulty with a universal compensation scheme for direct investors is who pays for it and should all investors be levied at the same rate irrespective of the risk they take on? If a levy is charged on all investment products, inequitable situations may arise where investors in conservative or low risk investment products or major institutions are funding a scheme they may never use and that is more likely to be used by investors in 'riskier' investment products. Conversely, if a levy was limited to particular products the cost may well be prohibitive for individual investors.<sup>43</sup>

...

Depending on the make-up of a universal compensation scheme, the potential 'moral hazard'<sup>44</sup> would also need to be considered. Investors may be encouraged to make riskier investment decisions and product providers market more high risk products if they believed they may be compensated if these investments failed.<sup>45</sup>

3.53 The Australian Taxation Office (ATO), the current regulator of SMSFs, also expressed concern that the introduction of a last resort compensation could result in investors engaging in riskier behaviour. It argued:

Across a large population of people such as SMSF trustees a level of incorrect or inappropriate, and borderline, claims will inevitably arise. The range of matters giving rise to such cases would be expected to include:

—misunderstanding about the criteria for compensation (e.g. claims in relation to 'poor' professional/investment advice are likely – there is a fine line between a 'bad' investment and a fraud);

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41 Financial Planning Association of Australia, *Submission 46*, p. 36.

42 Financial Planning Association of Australia, *Submission 46*, p. 36.

43 CPA Australia, *Submission 34*, p. 2.

44 Moral hazard refers to a situation where a party insulated from risk behaves differently from how it would behave if it were fully exposed to the risk – risk arises because a person will not bear the full consequences or responsibilities of their actions and therefore acts less carefully than they otherwise would.

45 CPA Australia, *Submission 34*, p. 2.

—attempts to give the greatest possible scope to the relevant criteria (e.g. would damage or tampering to an asset that reduces its value, perhaps to nil, amount to constructive theft of the value of the item?);

—where investments take a downturn, experience shows that some individuals can seek to engage in ‘game playing’ (e.g. given the absence of arms length arrangements between SMSFs and the individuals who run them, some individuals may be seek to interchange assets as between themselves and the fund where differing compensation arrangements apply).<sup>46</sup>

3.54 The ATO also highlighted that the introduction of a last resort compensation scheme would result in additional administrative and compliance costs, given that many cases would involve complex matters of legal interpretation.<sup>47</sup> It also anticipated difficult evidentiary issues, such as determining if losses were due to bad investments or actual fraud or theft. The ATO noted that to restrict the number of claims and the associated compliance and administrative costs, the government could restrict the type and the range of investments potentially subject to compensation, and/or restrict claims to material amounts over a specified threshold.<sup>48</sup>

### **The committee's view on SMSF investor compensation**

3.55 Should there be a compensation scheme for those who invest through an SMSF and who lose money by reason of theft or fraud? There are several considerations that could bear on this question.

3.56 At face value, it may seem anomalous that there is no compensation scheme for SMSFs similar to the protections offered to investors in APRA regulated funds under Part 23 of the SIS Act. APRA regulated funds have the benefit of full-time professional managers, and yet the Act recognises that even these managers can fall victim to fraud in investing the money of their fund members. One could argue, therefore, that if there is a need for a compensation scheme covering money managed by professional managers, surely the need is even greater for money managed by individual investors. After all, SMSF investors will generally not have the same degree of professional skill as managers of APRA regulated funds.

3.57 Accordingly, a possible policy response would be to recommend a compensation scheme which provided compensation for money lost due to fraud or theft and was funded by a levy on SMSFs.

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46 Australian Taxation Office, *Submission 27*, pp 3–4.

47 Australian Taxation Office, *Submission 27*, pp 3–4.

48 Australian Taxation Office, *Submission 27*, pp 3–4.

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3.58 On balance, however, the committee does not support the introduction of a compensation scheme that places a levy on SMSF investors. It cites the following reasons:

- first, the whole notion of an SMSF is that—as its name suggests—the individual chooses to manage his or her own superannuation monies and act as the trustee of his or her own (small) fund. This brings with it greater risk and responsibility than being a member of an APRA-regulated fund. One of these responsibilities is to be alert to the risk of fraud and theft;
- second, SMSF investors, by definition, have chosen to 'go it alone'. A corollary of that choice is that if one investor does well and another does badly, there is no exposure to a levy or entitlement to compensate losses; and
- third, a compensation scheme should only be available in extreme circumstances. A system that effectively taxes the superannuation savings of all members to fund any losses incurred by any superannuation investor due to fraud or theft, must ensure that the circumstances in which the investor suffers loss or theft is minimised. With APRA regulated funds, the first line of defence against fraud and theft is a professional management team. By contrast, SMSF investors rely only on their own vigilance. Introducing a compensation scheme for SMSF investors would in effect expose all SMSF investors to bad decisions and lack of appropriate caution and prudence by other SMSF investors.

#### *A levy on managed investment schemes*

3.59 Another approach could be to examine the introduction of a compensation scheme for the situation where an investor in a managed investment scheme loses money by reason of fraud or theft on the part of the responsible entity of the managed investment scheme. A scheme along these lines could have provided protection to Trio investors. An SMSF investor who put money into the Astarra Superannuation Plan (of which Trio was the trustee), which was then invested in the ASF, would have been compensated through a levy on the ASF.

3.60 The committee recognises that the issues involved with a compensation scheme levying managed investment schemes would be complex. It raises the following questions:

- should the level of compensation be 100 cents in the dollar;
- should the compensation be funded by a levy on all managed investment schemes or only those in the same asset class; and
- how should fraud or theft be identified and who should make the determination?

*The Richard St. John inquiry*

3.61 In May 2012, the government-commissioned inquiry into a statutory scheme to compensate consumers of financial services delivered its final report.<sup>49</sup> Mr St. John concluded that it would be inappropriate to introduce a more comprehensive last resort compensation scheme. It argued that there would be an element of moral hazard if a last resort compensation scheme was introduced without a greater effort to put licensees in a position where they can meet compensation claims from retail clients. The report argued that this would reduce the incentive for stringent regulation of the compensation arrangements.

3.62 Instead, the St. John report concluded that priority should be given to improve the protection of retail clients through a more rigorous approach to compliance by licensees. In particular, it noted that the regulatory platform for financial advisers and other licensees needs to be more robust and stable before a safety net, funded by all licensees, is put in place.<sup>50</sup>

3.63 One of the report's key recommendations was that, to enable ASIC to play a more proactive role in administering the licensing regime with respect to compensation arrangements, it should be given clearer powers to enforce standards and to sanction firms. It recommended that one of these powers should be 'the ability to deal with disreputable industry participants'.<sup>51</sup> The report was unclear as to what these circumstances or these powers might be.

3.64 The St. John report did note that ASIC is able to take action on behalf of investors who have suffered a loss 'if it appears to be in the public interest to do so'. It identified cases where ASIC has succeeded in obtaining compensation for retail clients under section 50 of the ASIC Act. ASIC can take action to recover damages for fraud, negligence, default, breach of duty, or other misconduct. However, Mr St. John noted ASIC's position in choosing not to compensate Trio Capital investors under section 50 of the ASIC Act.

3.65 The St. John report did comment on compensation Trio Capital investors in APRA-regulated superannuation funds relative to the exposure of SMSF investors. The report stated:

The policy rationale for the exclusion of SMSF trustees from Part 23 of the SIS Act is that, as trustees of their SMSF, they have direct control over their superannuation savings and unlike investors in other superannuation funds

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49 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. iii.

50 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. iv.

51 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 97.

are in a position to protect their own interests. It would be difficult also to justify levying other funds for fraud perpetrated within a closely held SMSF. They are subject to a less onerous regulatory regime and are not subject to levies under the financial assistance provisions. It is understood that the assistance scheme in Part 23 has been affirmed in several reviews over the years. My own disposition is to regard SMSFs for this purpose as more akin to private investors than to the broader based APRA-regulated funds for the protection of whose members Part 23 is designed.<sup>52</sup>

3.66 Mr St. John argued that introducing a statutory scheme to underpin existing compensation arrangements would not in itself provide relief for consumers such as SMSF investors in Trio. He argued that the ability of these investors to claim compensation would still depend on them being able to show they had suffered loss as a result of a breach by a licensee of a relevant obligation (such as dishonest conduct). Further, he argued that it is 'questionable' whether the law could impose obligations on a licensee that would allow consumers to be compensated for the fraudulent impairment of the value of an asset.<sup>53</sup>

3.67 One option the committee has considered is to provide compensation for SMSF investors in the case of theft and fraud through imposing a levy on managed investment schemes. The St. John report questions the merit of this approach, however:

Any move in that direction would, it is suggested, call first for a substantial upgrading of the regulatory regime for such schemes. It would be difficult to justify spreading the cost of investment losses through fraud across other scheme operators in circumstances short of some kind of prudential regime for those schemes.

...the regulatory treatment of managed investment schemes does not appear to provide a solid enough framework upon which to transfer to other licensees the cost of compensation for consumer loss resulting from licensee fraud. It would be difficult to justify a requirement for other licensees to pay compensation for a loss to consumers resulting from the deliberate actions of a fraudulent licensee for personal gain in the absence of some significant enhancement of the regulatory regime administered by ASIC.<sup>54</sup>

3.68 The committee agrees that there is a need to strengthen the regulatory regime for managed investment schemes (see recommendation 12). Mr St. John raises the possibility of imposing higher standards of risk management on managed investment

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52 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 97.

53 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 62.

54 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 62.

schemes. He noted that APRA regulated superannuation funds are currently required to have in place a risk management strategy dealing with the material risks of the trustees and each fund.<sup>55</sup> Imposing a similar system on management schemes, with independent assessment by an auditor, could help protect investors. However, Mr St. John adds that this system 'might be of limited value in circumstances where fraudulent conduct is endemic in the management and operation of a managed investment scheme'.<sup>56</sup>

3.69 In terms of whether SMSF investors in Trio Capital might be compensated through the retail client test in Chapter 7 of the *Corporations Act 2001*, Mr St. John argued the need for greater clarity on those circumstances in which trustees of SMSFs are treated as retail clients.<sup>57</sup>

#### *Committee view*

3.70 The committee notes that the recently commissioned St. John Review has considered the question of whether there should be a last resort scheme for financial services products, to compensate consumers of financial services in the event of loss suffered by reason of the product provider failing to operate to the appropriate standard. The St. John report recommends against such a scheme, amongst other things because it would impose upon well managed product providers the obligation to bear losses incurred by badly managed or negligent providers.

3.71 However, Chapter 6 of St. John's report sets out some elements of how such a scheme could work if government were to decide to proceed with such a scheme. The report states that SMSFs would not be included in the scheme.

3.72 The committee believes that if such a scheme were to be introduced, it could possibly have assisted SMSF investors in the Trio case. These investors lost their money because their SMSF invested in a managed investment scheme of which Trio was the responsible entity. Under the scheme described in Chapter 6 of the St. John Review, Trio would have been found to have failed to meet the relevant standard; Trio would have been liable to pay compensation to its investors; but being insolvent and unable to pay the compensation, the last resort scheme would have come into operation. SMSF investors (as well as direct investors) would have received compensation.

3.73 If the policy objections raised by Mr St. John to the operation of such a scheme can be overcome, the committee considers that it has merit and would have

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55 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 63.

56 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 63.

57 Mr Richard St. John, *Compensation arrangements for consumers of financial services*, April 2012, p. 65.

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assisted to reduce the detriment suffered by innocent Australian investors in the Trio case.

3.74 Separately, the committee considers that there would be merit in establishing an insurance scheme to which SMSFs could 'opt-in', enabling them to have protection against loss by reason of fraud or theft. One possible way this could work would be for the ATO or ASIC, on behalf of the SMSF sector, to enter into arrangements with an insurer. The insurer would specify the amount of the premium it required to offer the insurance, and the premium would be collected from participating SMSFs each year, along with their tax, by the ATO, and paid to the insurer. The insurance policy would be written, as much as possible, so that the circumstances in which the SMSF could claim would be the same as the circumstances in which investors in an APRA regulated fund can claim compensation. Alternatively, the scheme could be administered by government.

3.75 The committee recommends that the government consider policy options for such an opt-in compensation scheme for SMSFs.

*Specific compensation matters arising from Trio*

3.76 The committee recommends that the government consider the specific question of compensation for those Australians who lost their SMSF balances as a result of the Trio collapse. In particular, several investors were induced to move their money from the Professional Pensions Pooled Superannuation Trust (PPPST) to the ARP Growth Fund in 2007. It is now known that ARP was a fraudulent scheme, leading to the money being lost. Given that Pooled Superannuation Trusts (PSTs) are regulated under the SIS Act and have the benefit of the compensation scheme in that Act, the question arises as to whether compensation is available because investors in PPPST lost money by reason of fraud or theft.

### **Recommendation 1**

**3.77 The committee acknowledges the shortcomings, identified by Mr Richard St. John, of a statutory compensation scheme for consumers of financial services, and a scheme of financial assistance for investors in managed investment schemes along the lines of Part 23 of the *Superannuation Industry (Supervision) Act 1993*. However, the committee recommends that further efforts be made to investigate avenues to protect investors in the case of theft and fraud by a managed investment scheme.**

**The committee recommends that the government assist those who invested in the Professional Pensions Pooled Superannuation Trust (PPPST), and were induced to move their funds to the ARP Growth Fund.**

