28 June 2017

EDR Review Secretariat
Financial System Division
Markets Group
The Treasury
Langton Crescent
PARKES ACT 2600

By Email: EDRreview@treasury.gov.au

Dear Members of the EDR Review Panel

EDR REVIEW

Please refer to the attached submission in relation to the additional Terms of Reference of the Review Panel and the associated Supplementary Issues Paper.

I would be pleased to elaborate further on any aspect of my submission as required.

Yours sincerely

Steve O'Reilly
oreillys@aanet.com.au

SUBMISSION TO EDR REVIEW PANEL IN RESPONSE TO SUPPLEMENTARY ISSUES PAPER

1. Focus

This Submission responds to the EDR Review Panel's Supplementary Issues Paper dated May 2017 and provides input on the operation of a compensation scheme of last resort and the issue of redress for past disputes.

2. Executive Summary

In line with many other submissions received by the EDR Review Panel, I believe that a compensation scheme of last resort within the financial services sector is warranted, and that such a scheme should also operate retrospectively to cover unpaid EDR Determinations. Further information is provided in Section 4 below.

In order to provide redress for past disputes, I would strongly suggest that there is another category of claimants who should be included, and who have been to date overlooked by the EDR Panel, namely claimants who submitted disputes but who were denied fair and proper process. This would encompass claimants who lodged investment and insurance disputes with the Financial Ombudsman Service and who were subjected to decisions which unfairly favoured the FOS member, and claimants who had their disputes summarily dismissed, or unnecessarily excluded, at the discretion of FOS. With around 95% of investment disputes having been determined by FOS in favour of the FOS member, the EDR Review Panel has a golden opportunity to provide redress to investor claimants and to assist in rebuilding trust in the financial services sector. Further information is provided in sections 5 and 6 below.

Brief comments on the various questions raised in the Supplementary Issues Paper in relation to the design of a compensation scheme of last resort are provided in Section 8.

3. Personal Background

My background is as an Actuary with more than 30 years of professional experience in financial services.

I am also a principal of the Prime Trust Action Group, an organisation with more than 6,500 members formed in 2010 following the collapse of the Prime Retirement & Aged Care Property Trust and the associated investor losses of more than $500m, with a number of proceedings currently continuing through the Courts.

4. Compensation Scheme of Last Resort

I would fully support the establishment of a compensation scheme of last resort and consider that such a fund is long overdue.

I note that similar compensation schemes covering the financial sector already operate in other developed economies and that a number of other Australian industries are already covered by compensation schemes.

I am aware of cases where investors have lodged disputes to the Financial Ombudsman Service ("FOS") only to find that:

- the FOS process takes an inordinately long time (often exceeding two years);
- eventually, despite stalling tactics adopted by the Financial Services Provider ("FSP") and the slow and convoluted manner in which FOS processes disputes [1], the investors obtain a FOS Determination in their favour;
- the compensation amount awarded by FOS cannot be satisfied because the FSP has subsequently entered administration and the proceeds of the Professional Indemnity Insurance policies have been exhausted by claims made against the policy by the directors.

A compensation scheme of last resort would enable claimants in the above circumstances to achieve some closure from their dispute and some reward for their commitment over several years in pursuing justice, and some return from the large workload and considerable stress that bringing such a dispute entails.

I note that some cases may potentially arise where a successful EDR complainant may receive only part of the compensation awarded, for example, due to the application of an excess by the Professional Indemnity Insurer or by policy limits being reached, in which case, the claimant should be entitled to subsequently claim any unpaid balance from the compensation scheme of last resort.

As noted in a number of other submissions, including the submission from FOS, I believe that a compensation scheme of last resort should operate retrospectively, encompassing cases where there are existing unpaid EDR determinations.

I would strongly disagree with any suggestion that the establishment of a compensation scheme of last resort creates a moral hazard. My view is that any individual who knowingly purchased a financial service on the basis that, in the event of loss, a claim could easily be made on the compensation fund, would be severely misguided. In order to potentially claim on the compensation scheme, an individual has to first navigate a convoluted and time consuming assessment process before the claim can be accepted as being within the jurisdiction of the EDR Scheme, then establish the basis for claim and potentially spend several years (as I and others have done) pursuing an EDR Determination and rebutting all defences and legal technicalities put forward by the FSP and the EDR Scheme. As the entire drawn out process involves considerable personal cost and stress for the individual concerned, I believe it is fanciful to suggest that the compensation scheme would lead to a change in consumer behaviour and a willingness to embrace additional risk.

5. **Redress for Past Disputes**

I would generally support the approach taken by the EDR Review Panel in considering this issue but also believe that the Panel has overlooked a very significant item.

The particular issue I wish to raise with the Panel concerns investment disputes, which are primarily complaints by investors against fund managers or Responsible Entities. Investment disputes have special characteristics which make them quite different from the other complaints that FOS may consider.

[1] My Submission to the EDR Review Panel dated 6 October 2016 provides further details

Investment disputes differ from the general disputes referred to FOS in two significant ways:

(1) Whereas many of the disputes which are referred to FOS are for modest amounts of compensation, investment disputes differ because the amounts invested are typically quite large which naturally flows through to large amounts of compensation being sought by the claimant;

(2) Investment disputes often centre on alleged misconduct by the fund manager or Responsible Entity (whether it be a defective Product Disclosure Statement, misleading and deceptive conduct, breaches of the Constitution, breaches of the Corporations Act, or failure to exercise reasonable care), and therefore have the potential to create a precedent through which other investors can lodge similar claims.

It is noted that complaints lodged to FOS by investors against financial advisers can also be for large amounts of compensation, but the circumstances are usually unique to that dispute and therefore do not generally create a precedent through which other clients may seek to lodge similar claims.

As a result of the above two factors, namely claim size and establishment of precedent, fund managers have a strong incentive to ensure that investment claims lodged to FOS are unsuccessful.

As outlined in detail in my Submission dated 6 October 2016, there is clear and compelling evidence suggesting that FOS, when adjudicating on investment disputes, unfairly favours the interests of its own members at the expense of the claimant. After trawling through the FOS database of decisions, it was found that 95% of investment disputes were decided in favour of the FOS member (comprising 87% of disputes decided wholly in favour of the FOS member and a further 8% of disputes decided largely in favour of the FOS member) and only 5% of disputes were determined wholly in favour of the complainant, including cases where the fund manager did not contest the dispute.

It was also noted in my earlier Submission that long sequences of investment disputes have been observed to be decided in favour of the FOS member. A highlighted case was the series of more recent investment disputes, being those with FOS Dispute Numbers 300,000 and above, where it was observed that 21 consecutive investment disputes were decided wholly in favour of the FOS member (and of course wholly against the claimant). Even if it is conservatively assumed that a claimant has a 50% chance of success, the probability of all 21 cases in succession being decided wholly in favour of the FOS member, is an astronomical 1 in 2 million, which clearly and overwhelmingly points to a complete absence of impartiality in determining investment disputes.

Despite the compelling evidence presented in my earlier Submission on the issue of whether FOS, an organisation funded by its members, delivers fair and unbiased dispute outcomes to consumers, I note with concern that the Panel has not acknowledged or discussed these very serious issues in the reports and recommendations produced by the Panel to date.

I note that the Supplementary Issues Paper makes the point that, in cases where a claimant has accessed the relevant EDR mechanism, the Panel's view is that further redress is not available [2]. If there was evidence to support the proposition that FOS is determining disputes fairly and independently, then I would concur with the Panel's approach. However, as demonstrated in detail in my earlier Submission, the evidence strongly and unequivocally supports the proposition that FOS is not properly fulfilling its duties in determining investment disputes, and is failing to act independently by unfairly favouring its own members at the expense of claimants.

[2] Supplementary Issues Paper, paragraph 35

Given the manner in which FOS has been observed to repeatedly and consistently exercise its discretion in favour of its own members at the expense of investor claimants, it is strongly recommended that such claimants be provided with the opportunity to access redress.

As per my earlier Submission, there is also compelling evidence suggesting that insurance disputes have also not been determined fairly by FOS and accordingly, there are also strong grounds for allowing these claimants the opportunity to seek redress.

It is suggested that the following mechanism would be appropriate in order to reinstate fairness and equity in determining investment and insurance disputes, and to rebuild trust and confidence in the dispute resolution system:

- All investment and insurance claimants who had their FOS complaint wholly (or partly) decided in favour of the FOS member to be provided with the opportunity to have their dispute reassessed by a suitably qualified, professional independent party

- Investment and insurance claimants be given a period of six months to decide whether they wish for their dispute to be reopened

- Given their specialist knowledge of investment, insurance and financial matters, and their widely recognised impartiality, all reopened disputes to be assessed by independent actuaries as recommended by the Institute of Actuaries of Australia

- In terms of the costs of reassessing the past disputes, a number of funding alternatives are available, although a shared model whereby contributions are provided by the FOS member (the party which benefitted from a highly questionable dispute resolution service where 95% of investor claims are dismissed) and FOS itself (the party directly responsible for the 95% success rate in favour of FOS members) would be seen to be the most appropriate and would avoid the need for government funding

- FOS members (and potentially their professional indemnity insurers) to be responsible for the cost of paying any amounts of compensation determined following the independent review of the reopened disputes

- In the event of the FOS member being insolvent and therefore being unable to satisfy the amount of awarded compensation, the claimant would have the opportunity to claim from the compensation scheme of last resort

6. Exclusions in FOS' Terms of Reference

Consumers are informed that, if they have a dispute with their FSP, they can access the internal dispute resolution scheme operated by the FSP and, if necessary, subsequently escalate their dispute to FOS.

However, in practice, there is an alarming dichotomy between consumer expectations and dispute outcomes. Over the four years ending 30 June 2016, FOS, an organization funded by its members, exercised its discretion to exclude or dismiss no less than 20,910 disputes. [3]

Each year, approximately five to six thousand consumers have their disputes summarily dismissed by FOS, and in so doing, aggrieved consumers are denied access to the dispute resolution system. Disputes are routinely excluded from consideration by FOS due to the application of an exclusion from the FOS Terms of Reference. Remarkably, there are no less than 37 grounds which FOS can use to exclude disputes [4], and many of these grounds are at the discretion of FOS. Each of these exclusions limits the range of disputes that can be considered and of course limits the opportunity for consumers to seek redress.

As always, the devil is in the detail, in this case an inordinately long list of exclusions buried within the FOS Terms of Reference, which appears to have been carefully designed to exclude as many disputes as possible and thereby minimise the liability of the FOS members.

Large numbers of claims are excluded if FOS:

- deems there to be a *"more appropriate place"* to consider the disputes (1078 claims excluded on this basis in 2015-16 alone);
- deems disputes to be *"outside the Terms of Reference"* (919 claims excluded in 2015-16);
- exercises a *"general discretion"* to exclude disputes (790 claims excluded in 2015-16); or
- deems disputes to relate to *"FSP practice / policy"* [5] (499 claims excluded in 2015-16).

In addition, within the realm of investment disputes, in my experience, FOS often exercises a discretion to dismiss claims if the claims, in their opinion, relate to the *"management of the fund or scheme as a whole"*. From the consumer's viewpoint, the above several types of exclusion are often unnecessary and indeed unwarranted. Consumers are told that, if they have any issue with the FSP, then they are entitled to seek redress from the FSP and then if necessary escalate the issue to FOS. Consumers are not told that many disputes cannot be considered by FOS. The overriding consideration in considering a claim should be whether the consumer suffered a loss due to the actions or inactions of the FSP, not whether the case falls within a long list of exclusions, each of which serves to reduce the liability of the FSP. If a claimant has a dispute against a FSP, then this dispute should be capable of being considered as long as the individual has suffered loss, and the ability of FOS and FSPs to reject disputes, based on self-serving and unnecessary exclusions, needs to be dramatically curtailed.

It is recommended that the Terms of Reference of the proposed new dispute resolution body, the Australian Financial Complaints Authority ("AFCA"), be reviewed in order to enhance consumer protection by eliminating all unfair, unnecessary and over-reaching exclusions.

---

[3] FOS Annual Review 2015-16, page 55

[4] FOS Annual Review 2015-16, page 56

[5] FOS Annual Review 2015-16, page 56

It is also recommended that all claimants who have suffered loss but had their dispute unfairly and unnecessarily excluded by FOS be able to access the redress mechanism.

7. Professional Indemnity Insurance

For many years, fund managers and other FSPs have tended to maintain only minimum levels of professional indemnity ("PI") insurance cover. Despite an obligation under their Australian Financial Services Licence to maintain an *"adequate"* amount of PI cover, many fund managers are holding PI cover of only nominal amounts (often $5m) whilst simultaneously managing hundreds of millions of dollars, or even billions of dollars, on behalf of investors.

In some cases, investors in collapsed trusts have received FOS determinations in their favour only to find the entire PI cover consumed by the directors, leaving nothing for investors. This points to a fundamental flaw in the PI concept in striving to provide protection for two separate groups, directors and investors, with the directors of course being in a preferential position in terms of claiming on the policy. In order to address this issue, it is recommended that all fund managers be required to effect a commensurate but separate PI policy for the exclusive protection of investors. This policy would enable funds to be paid directly from the insurance company to the relevant claimant. Such a policy would complement the introduction of the compensation scheme of last resort and ensure that a further potential source of funds would be available to meet EDR determinations, and reduce the potential drain on the compensation scheme of last report. Further benefits would be realised in that, for those parties continuing to operate, FSPs found to have acted inappropriately would be required to contribute towards the associated compensation by way of meeting any excess under the policy and the future insurance premiums levied on each FSP would reflect the degree of general misconduct and misbehavior by the FSP.

Although the industry has a dubious track record in generally only effecting minimum or modest amounts of PI cover, it is suggested that the separate PI policy for the protection of investors be for a sum insured of no less than the cover provided under the directors' PI policy.

8. Compensation Scheme Design

In terms of the specific issues raised in the Supplementary Issues Paper relating to scheme design, I am pleased to attach brief specific comments in response to Issues 14-31 inclusive.

Questions — Potential design of a compensation scheme of last resort

14. What are the strengths and weaknesses of the ABA and FOS proposals?

The ABA proposal is largely self-serving and attempts to reduce the potential amounts paid from the compensation scheme by:

* making the scheme prospective only

* limiting claims to financial advice only

* limiting claims to cases where validated insolvency has occurred

* requiring all other avenues to be exhausted before claiming, thereby potentially adding many years to the dispute resolution process

* using an industry body to administer the scheme, thereby creating an untenable conflict of interest and the potential for the compensation scheme to not operate impartially

The FOS proposal, on the other hand, argues that all unpaid EDR claims (both prospective and retrospective back to 2008) should be paid without the various limitations suggested by the ABA proposal.

My view is that the FOS proposal represents a much fairer way of implementing a compensation scheme of last report.

15. What are the arguments for and against extending any compensation scheme of last resort beyond financial advice?

Financial advice disputes are merely a subset of the total disputes submitted to EDR bodies each year, and to limit the compensation scheme to those disputes would be to unnecessarily limit the scope and effectiveness of the scheme, and do little to restore faith in the entire financial services sector. By way of example, in cases where managed funds and insurance companies have acted inappropriately, clients deserve compensation just as much as clients who suffered as a result of their financial adviser acting inappropriately.

16. Who should be able to access any compensation scheme of last resort? Should this include small business?

The compensation scheme should be available to all EDR claimants, whether they be individuals or small business.

Given the current legislative and regulatory approach towards professional, sophisticated or wholesale investors, it is suggested for consistency that these investors would be unable to access the compensation scheme.

17. What types of claims should be covered by any compensation scheme of last resort?

All claims submitted to an EDR scheme should have access to the compensation scheme if part or all of their determination is not paid.

18. Should any compensation scheme of last resort only cover claims relating to unpaid EDR determinations or should it include court judgments and tribunal decisions?

It is suggested that the priority should be to compensate those claimants who pursued their dispute through an EDR scheme. Ideally, however, Court judgments and tribunal decisions would also be covered by the compensation scheme, but limited to the same compensation caps applying to unpaid EDR Determinations.

19. What steps should consumers and small businesses be required to take before accessing any compensation scheme of last resort?

A three step process is suggested as follows:

(1) Claimant would obtain an EDR Determination in their favour awarding compensation.

(2) In order to demonstrate that the claimant has not been paid the full amount of the awarded compensation, or only received partial compensation, a statement from the FSP (as represented by the appointed Administrator or Liquidator) to this effect would be sufficient. In order to avoid cases where the FSP (or Administrator or Liquidator) failed to provide the required statement, it would be important for the compensation scheme to have the statutory power to compel the production of these statements, or to waive this requirement.

(3) A statutory declaration from the claimant stating that they have not received part or all of the awarded compensation amount, and confirming that they are not entitled to claim under any other compensation scheme (or declaring the amount of compensation received from other sources) would be required.

20. Where an individual has received an EDR determination in their favour, should any compensation scheme of last resort be able to independently review the EDR determination or should it simply accept the EDR scheme's determination of the merits of the dispute?

It is suggested that the compensation scheme would simply accept the EDR Determination. It would be most unfortunate, and arguably unfair, if the claimant, having often spent a few years pursuing their dispute through EDR and having finally obtained a determination in their favour, to have to again endure a similar and potentially time consuming process through the compensation scheme which may reduce or even cancel their awarded compensation amount.

21. If a compensation scheme of last resort was established and it allowed individuals with a court judgment to access the scheme, what types of losses or costs (for example, legal costs) should they be able to recover?

My view is that any party succeeding in Court action is entitled to also recover their legal costs, in which case this amount (or at least a reasonable portion of this amount) would be claimable from the compensation fund to the extent that the costs are not reimbursed by the unsuccessful party in Court.

22. Should litigation funders be able to recover from any compensation scheme of last resort, either directly or indirectly through their contracts with the class of claimants?

The basic principle I would support here is that if there has been misconduct or inappropriate behaviour from the FSP, then the obligation to pay compensation arises, irrespective of whether remedy is sought by an individual or by a group of individuals acting collectively. It follows therefore that a collective or class action should have access to the compensation scheme, however it is suggested that the compensation scheme be required to pay compensation direct to individual claimants only, with the individual claimant to separately agree terms with the party organising any collective action.

23. What compensation caps should apply to claims under any compensation scheme of last resort?

It is suggested that the compensation caps would simply follow those of the EDR scheme.

24. Who should fund any compensation scheme of last resort?

The scheme should be wholly funded from industry.

25. Where any compensation scheme of last resort is industry funded, how should the levies be designed?

It is suggested that the funding models as used overseas would be appropriate for application to the Australian market.

The levies should be designed to cover the expected compensation claims over the following year, plus a contingency margin and a margin for the administrative expenses involved in running the compensation scheme. Levies would depend on the industry in which the FSP operates and the FSP's size, with the amount of levies raised from each industry adjusted each year in line with the overall claims experience from that industry.

26. Following the payment of compensation to an individual, what rights should a compensation scheme of last resort have against the firm who failed to pay the EDR determination?

Following the payment of compensation from the scheme to a successful EDR claimant, the scheme should stand in the place of the claimant and be entitled to share in any subsequent recoveries that may be arise from the insolvency process, so as to avoid the potential for a claimant to recover more than the determined losses.

27. What actions should ASIC take against a firm that fails to pay an EDR determination or its directors or officers?

In cases where an EDR Determination is unpaid, and recognising that the directors involved in the unpaid EDR Determination are likely to hold other directorships, ASIC should review the case and consider whether it is appropriate to impose sanctions or penalties on the directors involved, and review whether the directors are entitled to continue to hold any Australian Financial Services Licences or other position that requires them to be a *"fit and proper person"* or of *"good fame and character"*.

In order to act as a deterrent and also minimise the probability of further consumer losses arising from similar misconduct or inappropriate conduct, the details of all unpaid EDR Determinations, including the name of the entity unable to pay the compensation, and the names of all directors of that entity, should be published. The publication of this information could be done by ASIC or the compensation scheme.

28. Should any compensation scheme of last resort be administered by government or industry? What other administrative arrangements should apply?

In view of the industry's poor reputation over many years in self-regulation and managing conflicts of interest, the compensation scheme must be, and be seen to be, completely impartial and independent, by being entirely free of any relationship with the financial services industry. Ideally, the administration of the compensation scheme would be done through a government agency in order to provide the required arms' length independence.

29. Should time limits apply to any compensation scheme of last resort?

Ideally, all unpaid EDR Determinations would be covered by the compensation scheme, however the proposal by FOS to limit unpaid determinations to those arising from July 2008 appears to be a suitable compromise in the circumstances.

30. How should any compensation scheme of last resort interact with other compensation schemes?

The compensation scheme should interact with all existing targeted compensation schemes (such as the compensation scheme available to APRA-regulated superannuation funds) to ensure that claimants are not able to claim compensation from multiple sources. Any compensation paid by one scheme would be offset from the compensation payable by the other scheme. Ideally, the compensation scheme would share data with the targeted compensation schemes to ensure that claimants did not pursue multiple claims for the same event.

31. Are there any aspects of compensation schemes of last resort in other sectors and jurisdictions that should be considered in the design of any compensation scheme of last resort?

It is noted that the compensation schemes in the UK, US, EU and Canada are all industry funded, and in each case the administration is independent from industry, and it is recommended that the Australian scheme follow suit accordingly.

It is suggested that the compensation caps of the Australian scheme follow the new compensation caps to be adopted in the AFCA, and it is noted that these caps are broadly consistent with the caps currently applying to US and Canada.

Steve O'Reilly
28 June 2017
oreillys@aanet.com.au