Chapter 5: Rebalancing responsibilities of licensees

This chapter discusses an apparent imbalance in the responsibilities of issuers of financial products on the one hand and financial advisers on the other towards retail clients.

This imbalance stands out in any consideration of the current arrangements to provide those clients with assurance about the recovery of compensation where they suffer loss as a result of licensee misconduct. Substantial claims for compensation by retail clients often arise in the context of the failure of a managed investment scheme. Where retail clients suffer losses in such circumstances, those clients who invested on the basis of advice may be able to claim compensation from their adviser on the basis of the inappropriateness of that advice.

Other clients who purchased the product direct from the issuer, as is often the case, are unlikely to have an avenue for compensation. This is in part because of difficulties in attributing loss to shortcomings in the kind of disclosure issuers make to the market in general. Also, where a product issuer has failed consumers may see little point in pursuing a claim against the issuer owing to the poor prospect of recovery. It is noteworthy also how few complaints are brought against product issuers, as compared with financial advisers, under EDR schemes.

As a matter of strategic approach, it would be timely to review the current light-handed regulatory regime for the issue of certain financial products into the market, in particular managed investment schemes, and the possible need for some tightening of that regime. While the report does not reach conclusions in this regard, possible first steps in any such review would include the imposition on product issuers of more positive obligations in regard to the suitability of their products for retail clients as well as the introduction of standardised key product labelling.

Such an approach would be consistent with attention being given at the international level, following recent financial market turmoil, to the need for product issuers to assure the appropriateness of their product to retail consumers. The case for giving more attention to the responsibilities of product issuers is underlined by the prominence of direct consumer investment into products such as managed investment schemes.

This would be with a view both to providing better protection for clients, and reducing the instances of consumer loss, as well as paving the way for possible compensation claims where those obligations are breached.

Consideration is also given to related matters including the ability of EDR schemes to apportion responsibility for misconduct amongst relevant licensees including product issuers. The desirability of clarifying the scope of exclusion of disputes about the 'management of the fund or scheme as a whole' from the jurisdiction of FOS is also noted.

Licensee conduct and compensation obligations

5.1 The conduct and disclosure obligations imposed on licensees by Chapter 7 of the Corporations Act aim to protect retail consumers through the application to licensees of standards that require consumers to be informed about the features and risks of a product and not to be misled.

5.2 A consumer who acquires an interest in a financial product upon the basis of financial advice can expect the adviser to have provided personal advice that is appropriate to the consumer's circumstances. The Corporations Act requires the licensed adviser, in providing personal advice, to assess and make reasonable inquiries into the client's personal circumstances.[1]

5.3 On the other hand, a consumer who acquires a financial product direct from an issuer can look to the product disclosure statement to be clear, concise and effective.[2] The product disclosure statement should also cover certain matters, such as significant benefits and risks associated with holding the product, and information about any other significant characteristics or features of the product.[3] While aimed to elicit relevant information, these disclosure obligations are general in nature and will not necessarily draw out or point up information relevant to the circumstances of particular categories of consumers. The Corporations Act also prohibits licensees from engaging in dishonest, misleading or deceptive conduct in relation to a financial product or service, or from making false or misleading statements that are likely to induce persons to acquire a financial product.[4]

5.4 A consumer who suffers loss where a licensee has not acted in accordance with its statutory requirements may seek compensation. However, a consumer does not have an entitlement to compensation for loss in the value of their investment, such as where there is a failure of the product or the issuer or where returns are lower than expected, unless the loss can be attributed to licensee misconduct.

5.5 It has become apparent in the review that the failure of a managed investment scheme underlies many of the cases in which consumers find it difficult to recover compensation for losses attributable to licensee misconduct. Where consumers have acquired a product through an adviser they may, depending on the particular circumstances, be able to claim compensation on the basis of the inappropriateness of the advice that led them to invest in the product.

5.6 On the other hand, the many consumers who acquire those products direct from an issuer are unlikely to have such a claim. As a practical matter, very few claims seem to be brought against issuers of such investment products, whether based on misconduct in the description or marketing of that product or otherwise.

5.7 It is not questioned that financial advisers should bear responsibility for the consequences of inappropriate advice. They owe a responsibility to their clients, should be well informed about the products in question, and they are rewarded for the service they provide.

1 Section 945A *Corporations Act 2001*.
2 Paragraph 1013C(3) *Corporations Act 2001*.
3 Section 1013D *Corporations Act 2001*.
4 Sections 1041E, F, G and H *Corporations Act 2001*.

5.8 There is a question however whether they bear a disproportionate degree of responsibility for their part in the investment chain compared to the issuers of products whose failure generally underlies the losses suffered by consumers.

5.9 In practical terms those retail clients who dealt with a financial adviser stand a better chance of recovering compensation for misconduct than those who acquired their interest direct from the product issuer.

5.10 This is in part because of the difference in the nature of the responsibilities imposed on financial advisers compared to product issuers. The statutory expectations on financial advisers in dealing with a client on a one-to-one basis are more intensive than those on product issuers dealing with prospective clients on a whole of market basis.

5.11 Retail clients who invest direct in financial products are less likely to be able to recover compensation. This is in part because of the greater difficulty in making out misconduct on the part of a product issuer. It also reflects the reality that in some cases where loss is incurred the product issuer will itself has failed leaving little prospect of recovery of compensation.

Access to EDR schemes

5.12 The apparent imbalance in the responsibility towards consumers borne by product issuers compared with intermediaries is reflected also in the claims brought before EDR schemes by consumers. EDR schemes generally present consumers with an accessible avenue for the pursuit of compensation claims against licensees. Financial advisers appear to be shouldering almost all of the compensation awarded through EDR schemes in relation to managed investment scheme products.

5.13 FOS (the EDR scheme dealing with most investment related complaints) says that, by number of disputes, 'more than half (58 per cent) of the investment disputes it handled were about products or services provided by financial advisers or planners'. In dollar terms, the proportion of claims against financial advisers was even higher, representing 65 per cent of aggregate claims during the period 2006 to 2009.[5]

5.14 In comparison only 19 per cent of aggregate claims (in dollar terms) were against providers of managed investments.[6] The majority of the allegations of misrepresentation by a managed investment scheme brought to FOS appear to be about operational issues (such as the timing or approach to redemption requests, or costs of early termination of an investment) rather than about the misrepresentation or marketing of a product.

5.15 FOS has confirmed that it has handled only one dispute involving an allegation of misrepresentation by the licensee in its PDS. That case was decided against the responsible entity of the managed investment scheme. One other complaint involved an allegation of misleading and deceptive conduct in verbal representations in a sales presentation for a timeshare scheme, and was decided against the licensee.[7]

5 FOS data, see Table 2.1.
6 ibid.
7 FOS determinations 17681 and 208661 respectively.

5.16 It is noteworthy that so few complaints about product disclosure or marketing practices have been brought against product issuers, especially when questions have been raised about the accuracy or adequacy of disclosures made to consumers by particular product issuers (see Table 3.2).

5.17 There would appear to be two reasons for this imbalance in cases handled by FOS between the redress attainable in practice from financial advisers and product issuers (including responsible entities of managed investment schemes) for consumer losses arising from financial products that in some way might be regarded as having been mis-sold.

5.18 First, in many cases consumers only realise a loss on their investment when the product issuer fails. At that time, even if misrepresentation in a PDS or directly by the product issuer could be established, the consumer might see little value in pursuing a claim against a product issuer that is insolvent and might already have exhausted any professional indemnity insurance. The consumer would have little recourse to compensation in those circumstances other than as an unsecured creditor.

5.19 In such circumstances, consumers who invested in a managed investment scheme or other product through an intermediary may see their adviser as a better prospect for redress, provided there is some basis for a claim for inappropriate advice or other misconduct. Consumers understandably will pursue a claim against the most accessible target in the investment chain, not necessarily against a licensee who may also bear some responsibility for the loss.

5.20 Also it is generally a more straightforward matter to determine whether there was mis-selling or other misconduct by a financial adviser than by a product issuer given the one-to-one relationship an adviser has with each client. In providing personal advice to a client an adviser is obliged to provide advice which is appropriate to the client's personal circumstances having regard to the adviser's reasonable inquiries into those circumstances and its investigation of the subject matter of the advice. In contrast, in looking to the product issuer a consumer will, in the absence of any personal representations, only be able to rely on general disclosures or conduct to prospective investors as a class.

5.21 The second reason, according to FOS, is that as a matter of law a statement made by a product issuer at the time an investment is made is an implicit representation of present fact.[8] That is, the product issuer must believe the statements it makes to be true at the time they are made. For this reason FOS has told the review that it does not hold a product issuer liable for consumer loss resulting from changes in the nature of the investment that occur over time, for example because there has been a change in investment strategy for a scheme from that originally held out to investors.

5.22 It follows that, while EDR schemes generally appear to provide retail clients with a consumer friendly vehicle for pursuing claims, this course is almost non-existent where consumers have acquired financial products direct from an issuer and have not used a financial adviser.

5.23 Further, in assessing the compensation payable as a result of a breach, EDR schemes may consider whether there was any contributory negligence by the consumer who suffered the loss, but will not consider the liability of licensees other

8 Global Sportsman Pty Ltd v Mirror Newspapers Pty Ltd [1984] FCA 180.

than the licensee against whom the claim has been made (see paragraph 2.56). This means that, in the absence of any contributory negligence by the consumer, an adviser who recommended a financial product that was inappropriate might be liable to compensate the consumer's loss fully (subject to the scheme caps of $280,000) irrespective of the contribution of other licensees in the investment chain. That is, a product issuer's responsibility will not be taken into account in determining the award of compensation payable by the adviser.

5.24 It would be open to the adviser in theory to bring separate legal proceedings against the product issuer in regards to its contributory negligence. At best the adviser would have to carry the full compensation liability in the first instance, with subsequent partial recovery of the liability from the product issuer. In practice the adviser may not see separate legal action as worthwhile having regard to the cost of such action, or because the issuer is insolvent.

5.25 Another issue that seems to complicate the approach by FOS to complaints against product issuers is the exclusion from its jurisdiction of disputes about the 'management of the fund or scheme as a whole'.[9] In its operational guidelines, FOS says this is intended to exclude disputes about 'the day to day operation of the fund or scheme as a whole', such as investment decisions by the fund manager, or a dispute that 'applies to or affects all members of the fund or scheme'. While it is understandable that FOS should not be an arbiter on the internal operations of a scheme or fund, the exclusion is going too far if it denies consumers access to FOS in respect to misleading product disclosure statements or other practices in regard to the offering of products. There would seem to be a case, given some lack of clarity in this regard, for making it clear that such outcomes are not intended.

Scope to rectify imbalance

5.26 As noted above, it is arguable that a disproportionate burden is borne by financial advisers under the current arrangements. The costs of the compensation arrangements appear to fall heavily on financial advisers in comparison to product issuers. In turn this impacts on access to and the cost of professional indemnity insurance for advisers, and ultimately on consumer access to financial advice.

5.27 Reference is made in this regard to ICA's submission that:

> ...reinsurers being more selective in the risks they were willing to cover. This was particularly the case for a sector such as financial planning where there had been considerable losses in Australia due to several large scale financial collapses. These developments have been reflected in the pricing of PII.[10]

5.28 Overall financial advisers who have recommended financial products to their clients from issuers that have subsequently collapsed bear the brunt of compensation for consumer loss for those products and consumers who invested in those products direct have little prospect of compensation on the basis of licensee misconduct. Product issuers for their part do not appear to bear a proportionate responsibility, even where advisers acted on the basis of a misrepresentation of the product by the product issuer, or where the product issuer had set up a marketing arrangement for the distribution of its products direct.

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9 FOS Terms of Reference, 1 January 2010 (as amended 1 January 2012) paragraph 5.1(i).
10 ICA submission, page 1.

5.29 As a matter of strategic approach it would be timely to consider measures by which product issuers could assume more responsibility for the protection of consumers who look to invest in their products. The need for this is supported by the prominence of direct consumer investment with an estimated 70 per cent of investments in the managed funds industry being made direct and 30 per cent made through a financial adviser.

5.30 Given the focus of this review, it has not been possible to develop or test such an approach. However, reference is made below to the scope for reviewing the regulatory approach to the issue of financial products and to some possible measures to redress the balance of responsibility between financial advisers and product issuers.

Underlying regulatory approach to product issuers

5.31 More fundamentally, it may be timely to review the adequacy of the underlying conduct and disclosure approach to the regulation of financial product issuers as the means of protecting consumers. There has now been some ten years' experience of the current approach which relies largely on the disclosure of information to consumers and sets some standards for the quality of that information. Any additional measures would be aimed at reducing the risk to consumers that they acquire financial products that are not suited to their needs. They would be preventative measures that aim to reduce consumer loss, and the eventual need for consumer compensation.

5.32 The impact of the global financial crisis on consumers has led to a new focus by the international regulatory community on the adequacy of conduct and disclosure regimes. Consideration is being given to the possibility of a more interventionist approach with product issuers. The aim is to catch problems early on in a financial product's life cycle as a means of preventing widespread detriment to consumers.

5.33 FSA in the United Kingdom has said the regulatory reliance thus far on 'fair sales processes and transparent product disclosure' has been insufficient in protecting consumers from a series of product failures. FSA's analysis suggests that the disclosure regime has not overcome problems of asymmetric information for consumers, weakness in bargaining power with financial service providers nor incentives in the distribution chain that are not in the interests of consumers.[11]

5.34 In response, the UK Government has directed FSA to intervene 'more intensively at all points of the value chain' to 'seek to minimise consumer detriment'.[12]

5.35 Given the experience over recent years with consumer losses from the failure of managed investment schemes, it may be timely to undertake a policy review to determine whether a more interventionist regulatory approach towards product issuers is required to offer better consumer protection. Such a review could consider a range of possible measures such as:

- consumer and industry warnings for certain products;
- limiting sales of certain products to certain classes of consumers;

11 Financial Services Authority (UK) Discussion Paper D11/1, Product Intervention, January 2011.
12 Financial Services Authority (UK), Feedback Statement FS11/3, Product Intervention, June 2011, p7.

- preventing distribution of certain products in the absence of financial advice;
- mandating or banning of certain product features;
- a 'stop order' power to enable the regulator to intervene to halt the issue and distribution of 'toxic' products to retail investors (similar to the power that is available where ASIC is satisfied that information in a disclosure statement or document, or an advertisement, contravenes the statutory requirements on the product issuer);
- increased capital adequacy requirements for issuers of riskier products.

It is not suggested that a radical change of approach is required such as by a move to require pre-vetting of new investment products. There would seem to be scope however to consider changes that would adjust the regulatory approach in a stepped way.

5.36 In the light of recent experience in Australia and developments in overseas jurisdictions, it is suggested that the regulatory approach to the issue of financial products could usefully be reconsidered.

5.37 A first step in any such review might be to consider measures by which product issuers would be expected to assume more responsibility for the protection of consumers of their products. The objective would be to provide better protection for clients, and reduce the instances of consumer loss, as well as paving the way for possible compensation claims where those obligations are breached. Possible measures for consideration include the imposition on product issuers of more positive obligations in regard to the suitability of their products for retail clients and the introduction of standardised product labelling.

Product issuer responsibility to consumers

5.38 As has been noted most cases of large case consumer loss are associated with the failure of financial products, and managed investment schemes in particular. In such cases a common issue appears to be that consumers had not been properly informed of, or had not understood, the complexity, suitability or risks of their investments.

5.39 Under the current regulatory approach, there is limited regulation of the development and marketing of new investment products. There is no pre-vetting of new products and any financial product can be placed on the retail market by a registered and licensed financial product issuer if accompanied by the required disclosure statements.

5.40 As things stand, the Corporations Act requires product issuers when releasing a financial product to the market to issue a Product Disclosure Statement that:

- is worded and presented in a clear, concise and effective manner;[13]

13 Subsection 1013C(3) *Corporations Act 2001*.

- makes specific disclosures, including about any significant benefits which the holder will or may become entitled to, as well as any significant risks associated with holding the product;[14] and
- includes all other information that might reasonably be expected to have a material influence on the decision of a reasonable person, when investing as a retail client, about whether or not to acquire the product.[15]

5.41 The product issuer also has obligations to provide ongoing disclosure on material changes to the investment and significant events, and to provide periodic statements to investors.[16]

5.42 ASIC in its guidance in respect of various categories of financial products states that disclosure should include information, for example, about a responsible entity's financing arrangements, track record and financial position.

5.43 In practice, there is a question whether the information provided by product issuers in a PDS is framed in a manner that assists consumers to understand whether the product would suit their needs. For example, in assessing the quality of disclosure available to retail investors in agribusiness schemes ASIC has said that:

> many PDSs currently in use for agribusiness schemes do not adequately explain the way agribusiness schemes work, and the risks associated with investing in them (which) …has resulted in retail investors investing in these schemes without an adequate understanding of the risks.[17]

Further, in looking at infrastructure entities ASIC found that risks were often disclosed as a 'laundry list' which would be difficult for consumers to understand and consider in the context of their own risk profile.[18]

5.44 Whilst ASIC is pursuing improved product issuer performance in the area of product disclosure, overall there is a more fundamental question whether consumers might be better protected if more were expected of product issuers in releasing products to the retail market. There is a question whether issuers of financial products should have to take more responsibility for the suitability of new products made available to retail investors and for more forthright disclosure of matters such investors should take into account. This question is accentuated where, as is often the case, products are marketed direct to retail investors and not just through advisers.

5.45 Given the reliance on a PDS to provide information to consumers who invest direct, consideration might be given to requiring the inclusion of more guidance to assist consumers to make choices that are appropriate to their needs and help them avoid those that are not. ASIC has raised the need for consideration to be given to more stringent disclosure requirements at the asset level of registered managed

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14 Section 1013D *Corporations Act 2001*.
15 Section 1013E *Corporations Act 2001*.
16 Sections 675, 1017B and 1017D *Corporations Act 2001*.
17 ASIC Regulation Impact Statement, *Agribusiness managed investment schemes: Improving Disclosure for retail investors*, para 2.
18 ASIC Regulation Impact Statement, *Infrastructure entities: Improving Disclosure for retail investors*, paragraph 29.

investment schemes as a means of placing consumers and advisers in a better position to assess the exposure of such schemes to particular assets.[19]

5.46 Another possibility would be to have product issuers disclose in the PDS the potential suitability or unsuitability of the product for particular classes of investors or risk profiles. While a suitability statement by a product issuer could not address the circumstances of an individual investor, statements of characteristics relevant to particular categories of consumers would help consumers to ascertain whether or not a product is potentially suitable for them.

5.47 A product issuer would of course need to take care that the terms of any suitability statement were not misleading, for example by implying that any individual from a targeted class would find the product suitable to their needs. It would be a matter for consideration whether a suitability requirement should extend to financial products, such as simple managed investment schemes, that will be subject to the shorter form PDS from mid-2012.[20]

5.48 A suitability requirement could be designed to apply at every stage of a product's life cycle, from design and development, to distribution and operation. For example, it might aim for a more rigorous process of product development before a product is released, such as stress testing of the risks to assess the product's performance in a range of market conditions to give the issuer a more realistic basis for disclosure statements on the product's risks.

5.49 The breach of a suitability requirement would be subject to administrative sanctions and, where consumer loss can be established, it would provide a basis for compensation.

5.50 An obligation to assess the suitability of products for consumers already applies as part of the responsible lending conduct required of licensed credit providers. Credit providers are obliged to ensure they do not provide a credit contract that is unsuitable for the consumer.[21] A similar obligation applies to margin lenders who are required to ensure, before issuing or increasing a margin loan, that it is not unsuitable for a retail client after making reasonable endeavours to verify the client's financial situation and capacity to meet repayments.[22]

5.51 In both of those cases the provider is dealing with the retail client on a one to one basis and is in a position to assess the suitability or otherwise of the product given its ability to assess the consumer's personal and financial circumstances. Statements by product issuers to the retail market about the suitability of a product might need to be more broadly based, whilst framed in a way that is useful and not misleading. Where the product issuer has direct dealings with a consumer it might be required to go further in providing guidance at the point of sale.

5.52 The application of a suitability requirement to product issuers on a life cycle basis, or some alternative that looks at placing more onus on issuers to provide products that are appropriate to their target consumer market, is worth further consideration. There is growing attention at the international level to the need for

19 ASIC Submission to PJCCFS, Inquiry into the collapse of Trio Capital, August 2011, paragraphs 270 – 272.
20 'Corporations Regulation 1.1.02 defines 'simple managed investment schemes' and Schedule 10E *Corporations Act 2001* sets out form and content of PDF.
21 Chapter 3 *National Consumer Credit Protection Act 2009*.
22 Section 985K *Corporations Act 2001*.

product issuers to take on greater responsibility for the appropriateness of their products to retail consumers.

International developments

5.53 As noted above, questions are being asked by the international regulatory community about the adequacy of conduct and disclosure requirements for financial products and the need for a more interventionist approach.

5.54 The G20 Finance Ministers and Central Bank Governors recently endorsed common principles on consumer protection which include:[23]

- Principle 3 - *the equitable and fair treatment of consumers* - which requires:

  all financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial services providers...;

- Principle 4 - *disclosure and transparency* - which requires financial service providers and their authorised agents to:

  ...provide consumers with key information that informs the consumer of the fundamental benefits, risks, and of the product ..(and) on conflicts of interest associated with the authorised agent through which the product is sold...;

- Principle 6 - *responsible business conduct of financial services providers and authorised agents* - which requires them:

  ...to work in the best interest of their customers and be responsible for upholding financial consumer protection...depending on the nature of the transaction ...providers should assess the related financial capabilities, situation and needs of their customers before agreeing to provide them with a product, advice or service...

  ...where the potential for conflicts of interest arise, financial services providers and authorised agents should endeavour to avoid such conflicts. When such conflicts cannot be avoided …providers ...should ensure proper disclosure, have in place internal mechanisms to manage such conflicts, or decline to provide the product, advice or service.

5.55 The International Organization of Securities Commission (IOSCO) is currently consulting on *suitability requirements with respect to the distribution of complex financial products.* Its consultation paper sets out:

> proposed principles relating to the customer protections, including suitability and disclosure obligations, which relate to the distribution by intermediaries of complex financial products to retail and non-retail customers.[24]

In terms of disclosure, the proposed principles look to the provision of investor access to 'material information to evaluate the nature, costs and specific risks of the complex financial product' and to have the intermediary communicate to the investor 'in a fair, comprehensible and balanced manner'.[25] Further, IOSCO proposes that

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23 OECD, *G20 high-level principles on financial consumer protection* October 2011. The principles were developed by the Task Force on Financial Consumer Protection of the OECD Committee on Financial Markets, in close cooperation with the Financial Stability Board and others.

24 IOSCO, Media Statement 04/2012, 21 February 2012.

25 ibid, page 1.

where a complex product is sold 'on an unsolicited basis (no management, advice or recommendation), the regulatory system should provide for adequate means to protect customers from associated risks'.[26]

5.56 In the United Kingdom financial product issuers and distributors are subject to '*treating customers fairly'* obligations that aim to deliver improved outcomes for retail consumers.[27] These require amongst other things that products and services marketed and sold in the retail market are 'designed to meet the needs of identified consumer groups and are targeted accordingly'. This requirement applies to product issuers even if they distribute their products solely or mainly through intermediaries as is commonplace in that market. It also requires firms to keep consumers appropriately informed about the product before, during and after the point of sale, and to provide products that perform as they have led consumers to expect.

5.57 As noted above, FSA in the United Kingdom has said the regulatory reliance thus far on 'fair sales processes and transparent product disclosure' has been insufficient in protecting consumers from a series of product failures. The UK Government for its part has directed FSA to intervene 'more intensively at all points of the value chain' to 'seek to minimise consumer detriment'.[28]

Standardise key product labels

5.58 Consistent with the objective of requiring more guidance from product issuers to assist consumers to make financial product choices that suit their circumstances, it is suggested that consideration also be given to the adoption of standardised product labels across the industry. This would help to give consumers more clarity about the nature of the products they are looking to invest in, and help them to undertake more meaningful comparisons of 'like' products by different issuers.

5.59 The lack of common labelling for financial products, and the diversity of product descriptors used across the financial services industry at present, is likely to be confusing for consumers and not help them choose products appropriate to their needs.

5.60 There has been some effort already to specify the characteristics of certain financial products and their potential risks. In particular:

- the Corporations Regulations define the characteristics of a *capital guaranteed fund* with respect to public superannuation funds and require issuers of such products to provide certain information in the periodic statements provided to investors;[29]
- from June 2012, APRA will require superannuation funds to provide additional disclosure for their products and to identify and disclose, on a standardised

26 ibid, page 2.
27 Financial Services Authority (UK), *Treating customers fairly – towards fair outcomes for consumers,* July 2006. Specific reference is made to Outcomes 2, 3 and 5 on page 3.
28 Financial Services Authority (UK), Feedback Statement FS11/3, *Product Intervention*, June 2011, page 7.
29 Corporations Regulations 1.0.02 and 7.9.22.

basis, the risk of negative returns over a 20-year period for each of their investment options;[30] and

- as part of a current consumer credit Bill, it is proposed to restrict the use of the term *reverse mortgage* to those products which meet the definition in the *National Consumer Credit Protection Act 2009*.[31]

5.61 FSA in the United Kingdom has recognised the need for consistent labelling of products across the financial product industry. In a recent consultation paper, FSA notes that it has reviewed the promotion of financial products described as *guaranteed*, *protected* or *secure* and

> concluded that some firms promote these products without any clear and adequate justification for the descriptions used. [32]

FSA's assessment is that this

> could be implicitly misleading and could lead to consumers misunderstanding what is actually offered to them.

FSA has sought comment on its proposal to provide guidance in its rule book on the use of those terms and on the information to be given to consumers when promoting such products.

5.62 As a further measure to help guide consumers to make appropriate investments, and to avoid inadvertently taking on undue risks, consideration should be given to the standardisation of key labels for financial products, particularly managed investment scheme and superannuation products, across the industry so that products are described on a consistent and more meaningful basis. This might apply to such terms as: *capital guaranteed*, *capital protected; conservative; balanced; diversified; growth; defensive; fixed interest; or hedged*, as well as other like descriptors.

5.63 The development of standardised and generally accepted product labels is not likely to be a simple or quick task. It might be undertaken, on a progressive basis, by the regulator with involvement by industry and consumer groups. This could be done with a view to a regulatory requirement on the use of standardised labels in product disclosure statements and promotional material. The support of professional bodies might also be sought in making the use of standardised product descriptors a requirement of membership.

Allocation of cost of compensation between licensees

5.64 It is relevant, in any consideration of a rebalancing of responsibilities between product issuers and advisers, to look at the way in which investment disputes are handled through the EDR scheme process. There is scope for some rebalancing of responsibilities through changes to the operation of EDR schemes to facilitate a more

30 The standard risk measure to be used for this purpose was developed at APRA's request by a working group comprising the Financial Services Council and the Association of Superannuation Funds of Australia. See *Standard risk measure to provide greater transparency for consumers*, ASFA Media Release, 1 August 2011.

31 Consumer Credit and Corporations Legislation Amendment (Enhancements) Bill 2011.

32 Financial Services Authority (UK), Quarterly Consultation (No 29), Consultation Paper 11/11, June 2011, pages 27-28.

equitable distribution of the cost of compensation between financial advisers and product issuers.

5.65 As discussed earlier, EDR schemes only look to establish whether or not a financial adviser is liable for compensation but do not take into account any contribution to the loss by other licensees in the investment chain.

5.66 The adviser has no opportunity to draw into an EDR scheme dispute a product issuer that may rightfully share responsibility for the loss, but could take private legal action through the courts against the product issuer to seek to recover that part of the compensation liability that is attributable to the issuer's misconduct.

5.67 Given the quantum of claims that they can handle, EDR schemes should be open to assessing more holistically the circumstances that led to consumer loss by considering whether the loss was attributable to a breach by the relevant product issuer as well as financial adviser. This would allow a more equitable distribution of the cost of compensation between the respective licensees involved in providing the financial products and services that resulted in consumer loss.

5.68 To achieve this, the operating rules of EDR schemes would need to be made more flexible to allow a licensee against whom a claim has been made to bring another licensee member into the dispute to account for its role in the claimant's loss, or a consumer to bring an action against more than one licensee member in respect to the same loss. Such a course of action would be open for example where a consumer alleges false or misleading statements by the product issuer through its product disclosures as well as inappropriate advice by the adviser.

5.69 In such circumstances, if it were established that the claimant's loss resulted from a breach of obligation by both the product issuer and the financial adviser, the scheme would apportion the loss between the two licensees based on their respective contributions to the loss.

5.70 For practical reasons, financial advisers might need to be required to be members of the same EDR scheme as the issuer of the products represented in their approved product list.

5.71 Attention should therefore be given to changing the terms of reference of EDR schemes to make sure there is no obstacle to them considering disputes and making awards that recognise the proportionate liability of more than one licensee member. This would have a practical effect in rebalancing the responsibilities of financial advisers and product issuers to consumers, especially if coupled with a new obligation on product issuers for the suitability of their products.

5.72 Such a change would be consistent with the application of the principle of proportionate liability under Chapter 7 of the Corporations Act which applies to proceedings against a financial services licensee for recovery of loss or damage as a result of misleading and deceptive conduct.[33] Under these provisions the liability of a licensee that contributed to a loss is limited to an amount reflecting the proportion of the loss attributable to that licensee.

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33 Division 2A of Part 7.10 Corporation Act 2001. The provisions also preclude the apportionment of a claim where the concurrent wrongdoer intended to cause the loss or acted fraudulently.

5.73 It is recognised that a procedural change of the type suggested would introduce an element of complexity into EDR scheme proceedings. Given the substantial quantum of claims that EDR schemes can now deal with, such a change seems warranted and fair. It is hard to see why a licensee should be at a distinct disadvantage in defending a significant claim for compensation before an EDR scheme compared with its position in defending a suit brought in the courts. Such a change could be confined however to claims for significant monetary damages and not be applied to the numerous more minor or run of the mill disputes about the administration of financial products and services that are handled by EDR schemes.

Role of gatekeepers in protecting consumers

5.74 Although the review has not sought to explore the issue in any depth, the role of gatekeepers in guiding consumers to make investment decisions should be recognised. The Chairman of ASIC has pointed out that consumers rely on a range of information about financial products provided to them by various parties or gatekeepers who 'collect, evaluate, advise on and endorse information about companies, assets and investments'.[34] He noted that:

> investors and financial consumers rely on gatekeepers to act with the utmost integrity [and]...where they fail in their role, this can have serious consequences for retail investors and financial consumers.[35]

5.75 Reference has been made to the role of research houses in this context. Financial advisers use research reports to identify products for inclusion in their approved product list, from which in turn they draw products recommended to their clients. Consumers in effect become indirect users of research house reports through the financial advice they receive.

5.76 Research houses are required to hold a license authorising them to provide general advice and to meet the general obligations set out in section 912A. ASIC provides detailed guidance on one of those general obligations, that is, to have adequate arrangements for the management of conflicts of interest.[36]

5.77 ASIC recently released a consultation paper in response to industry and consumer concerns about whether research houses are adequately managing their conflicts of interest and providing high quality reports.[37] Some research reports had recommended products close to the time of the product issuer's collapse.

5.78 ASIC found limited awareness by research houses of their obligations and says it will need to revise them and educate the providers of research reports on the standards expected of them. Changes to RG 79 and licensing conditions being considered by ASIC relate to:

- the need for regular compliance reports to be lodged with ASIC;

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34 Greg Medcraft, ASIC Speech to FOS National Conference, June 2011, page 4.
35 ibid.
36 ASIC Regulatory Guide 79*, Managing conflicts of interest: A guide for research report providers.* November 2004.
37 ASIC Consultation Paper 171, *Strengthening the regulation of research report providers (including research houses),* November 2011.

- ensuring that conflicts of interest are properly managed in the research process (for example by requiring the segregation of the research function from the provision of other financial services) and are clearly disclosed;

- quality of research reports, both through the analysis and sign-off of the research, and the information provided to help users understand the material;

- the methodology used and its transparency.

5.79 Users of research reports have suggested to ASIC that research houses should be held liable for the general advice and recommendations provided in their reports when relied upon by advisers and consumers in making investment decisions.

5.80 Given the significant role played by gatekeepers, such as research houses, in the working of the financial services system, there is merit in continued efforts to clarify their responsibilities in regard to the protection of consumers. The significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.

Recommendations

There is an apparent imbalance in the responsibilities of the issuers of financial products on the one hand and financial advisers on the other towards retail clients. Financial advisers are subject to more particular responsibilities in dealing with retail clients and in consequence bear a greater part of the burden of compensation following the failure of financial products. While most cases of serious loss relate to the failure of financial products, consumers commonly only have recourse to compensation where they have acquired a product through a financial adviser and can point to inappropriate advice or other misconduct. They have little prospect of compensation where, as in many cases, they acquired the product in question direct from a financial product issuer.

As a matter of strategic approach, it would be timely to review the present light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach.

It would make sense also, in the course of any such review, to direct more attention to the responsibilities of licensees who provide financial products for retail clients. While the review has not had an opportunity to test these proposals, a first step might be to consider measures along the following lines by which product issuers would be expected to assume more responsibility for the protection of consumers of their products:

(a) Subject product issuers to more positive obligations in regard to the suitability of their product for retail clients.

Such obligations might be applied in particular to managed investment schemes in issuing products to the retail market, and would apply at each stage of a product's life cycle including its distribution and marketing. Amongst other things, the product issuer might be required to state the particular classes of consumers for whom the product is suitable and for

whom the product is unsuitable, and the potential risks of investing in the product.

(b) Consider the development of standardised product labelling so that financial products, particularly managed investment schemes, are described on a consistent and more meaningful basis.

This might apply to such terms as *capital guaranteed*, *capital protected, conservative, balanced, diversified, growth, defensive, fixed interest, or hedged*, as well as other like descriptors.

In addition, some rebalancing of responsibilities could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct amongst responsible licensees. The operating rules of EDRs should be changed to enable them to make awards that recognise the proportionate liability of product issuers, financial advisers or other licensees.

Further, there would seem to be a case to clarify clause 5.1(i) of the terms of reference of FOS which excludes consideration of disputes about the ‘management of the fund or scheme as a whole’. The aim would be to remove any doubt about the ability of FOS to deal with consumer disputes in respect of misleading product disclosure statements or other practices of issuers in marketing their products.

While the review has not looked into these matters in any depth, the significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.