

6 July 2012

The General Manager
Retail Investor Division
The Treasury
Langton Crescent
PARKES ACT 2600

By email: futureofadvice@treasury.gov.au

Dear Sir/ Madam

COMPENSATION ARRANGEMENTS FOR CONSUMERS OF FINANCIAL SERVICES – FINAL REPORT

CPA Australia, the Institute of Chartered Accountants in Australia, and the Institute of Public Accountants (the Joint Accounting Bodies) represent over 180,000 professional accountants in Australia. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

The Joint Accounting Bodies welcomes the opportunity to provide comments on proposals to reform the compensation arrangements for consumers of financial services. The financial services sector is undergoing radical transformation as a result of the Future of Financial Advice (FoFA) reform measures and therefore it is an opportune time to review the current compensation mechanisms.

The Joint Accounting Bodies agree with the conclusion of the report that it would be inappropriate to introduce a 'last resort compensation scheme'; we believe such a scheme is fraught with complexities and uncertainties which may introduce an unacceptable element of moral hazard to the system. Rather, we believe that it is appropriate that consumer compensation provisions are addressed through the existing professional indemnity (PI) insurance requirements and External Dispute Resolution (EDR) scheme mechanisms.

It is also important that ASIC engage with industry to ensure appropriate standards are developed. The Joint Accounting Bodies favour a co-regulatory environment whereby the regulator sets the minimum standards expected of all market participants and professional bodies seek to elevate their members above those standards. Without appropriate 'buy-in' of industry, effective reform will be stymied. We therefore recommend that ASIC work with industry to:

- develop appropriate PI Insurance requirements for particular market segments
- enforce ongoing PI insurance coverage of market participants
- ensure appropriate market supervision and enforcement activity against the small number of 'disreputable industry participants'; and
- review the EDR process on an ongoing basis and implement reform where necessary.

Representatives of the Australian Accounting Profession



cpaaustralia.com.au



The Institute of
Chartered Accountants
in Australia

charteredaccountants.com.au



INSTITUTE OF PUBLIC
ACCOUNTANTS

publicaccountants.com.au

It is also important that ASIC is both appropriately resourced and prepared to undertake necessary monitoring and enforcement action in relation to market supervision. If there is a belief by 'disreputable industry participants' that the regulator will not proactively monitor and enforce the law, these participants may be encouraged to continue to operate with disregard for the law. It may also have the unintended effect of encouraging further 'disreputable industry participants' to enter the sector.

ASIC must ensure confident and informed consumers participation in the marketplace. However, this will ultimately depend on their continued ability to effectively monitor and regulate the market which will also drive market participants to continue to raise the level of professionalism in the financial services sector.

If you have any questions regarding this submission, please do not hesitate to contact Keddie Waller (CPA Australia) at keddie.waller@cpaaustralia.com.au, Hugh Elvy (the Institute) at hugh.elvy@charteredaccountants.com.au or Reece Agland (IPA) at reece.agland@publicaccountants.org.au.

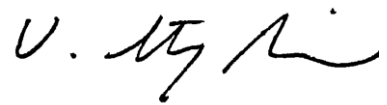
Yours sincerely



Paul Drum
Head – Business and
Investment Policy
CPA Australia Ltd



Yasser El-Ansary
General Manager, Leadership
and Quality
Institute of Chartered
Accountants in Australia



Vicki Stylianou
Executive General Manager –
Public Affairs
Institute of Public Accountants

COMPENSATION ARRANGEMENTS FOR CONSUMERS OF FINANCIAL SERVICES – FINAL REPORT

1. Last resort scheme

Recommendation 1: Last resort scheme

It would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage.

The Joint Accounting Bodies do not support the introduction of 'last resort' compensation scheme in relation to the provision of financial advice.

We are of the view that such a scheme would be both complex to develop and deliver. Further, it may introduce an element of moral hazard. Rather, we support the recommendations of the final report which we believe provides more effective options for improving compensation arrangements.

2. Strengthen current compensation arrangements

Recommendation 2.1: Licensees to demonstrate adequacy of their insurance

Require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs.

Every Australian Financial Services Licensee is required by law to ensure they have adequate arrangements for compensating their clients for breaches of Chapter 7 of the Corporations Act. The primary and most effective means to comply with this ongoing obligation is to have adequate professional indemnity insurance cover.

One of the overarching objectives of the FoFA reforms is to improve consumer trust and confidence in the financial services industry. The ability of a small number of market participants to effectively 'opt-out' of holding appropriate (or in some cases any) PI insurance not only places clients at risk, but has the potential to adversely impact the reputation of all market participants. This does not align with the objective of improving trust and confidence in the industry.

The Joint Accounting Bodies therefore support this recommendation and believe it is appropriate that all licensees to demonstrate on an ongoing basis that they have current PI insurance cover which is appropriate for the level of risk their clients face.

Further, we believe that ASIC should work with the industry to explore possibly mechanisms for implementing this recommendation in order to ensure the process is made as efficient as possible. Options may include incorporating this requirement into the annual compliance statement that all licensees are required to lodge with ASIC. Consideration could also be given to incorporate a further requirement to report the number of complaints to Financial Ombudsman Service and claims against PI cover in the previous 12 months.

To complement this we recommend that ASIC and the industry reconvene efforts to develop minimum PI insurance requirements for broad market segments. Advantages of implementing agreed minimum terms of cover include that it:

- would enable PI insurance providers to develop products that will be acceptable to a broad range of providers
- may aid in making it somewhat easier for licensees to source appropriate cover for their business, and
- may make it more efficient to regulate compliance with the compensation arrangements obligations.

Recommendation 2.2: Licensees to hold appropriate capital resources

More attention should be given, on a risk targeted basis and in conjunction with the level of their insurance cover, to the adequacy of licensees' financial resources to enable better management of risks and unexpected costs such as compensation liabilities.

Whilst we would support this recommendation, a measured approach must be taken to ensure any capital resource requirements remain flexible to cater for the varied market participants and the different types of advice and services provided in the financial planning sector.

Recommendation 2.3: A more pro-active stance by ASIC

ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate professional indemnity insurance cover and any new requirement in regard to financial resources, and in targeting licensees who are most at risk.

The Joint Accounting Bodies believe that the vast majority of participants in the financial services industry have their client's best interests at the heart of all advice and make every attempt to ensure they comply with the vast obligations of the law.

However, we believe confidence in the financial services sector would be improved if ASIC took a more proactive stance by implementing early and targeted monitoring of licensees they believe are most at risk, coupled with rigorous enforcement.

For this to be effective, ASIC must be appropriately resourced and consideration should be given to providing additional funding if ASIC does not have the current capacity to undertake this role.

Importantly, ASIC now has the sufficient means to deal with many of the concerns raised in the report. They must now ensure the supervision of the financial services sector is a priority and that appropriate oversight mechanisms are employed. This should include working closely with professional and industry bodies

Recommendation 2.4: Policing the licensing system in regards to compensation

To assist ASIC in playing a more pro-active role in administering the licensing regime with respect to compensation arrangements, consideration should be given to clearer powers to enforce standards and to sanction licensees who do not comply through:

- **powers to deal with phoenix activity, both through licensees establishing new entities or by former directors who re-emerge in the industry as authorised representatives;**
- **ability to deal with disreputable industry participants; and**
- **access to an infringement notice regime.**

ASIC for its part should be prepared to take action in appropriate cases to enforce its published views of what is required by the licensing conditions on insurance cover or financial resources. In the event that it becomes apparent that the current legal framework provides insufficient basis for effective enforcement action, consideration should be given to clearer legislative backing for regulatory standards on the adequacy of insurance or financial resources.

Phoenix activity undermines the effectiveness of regulation and confidence in the financial services sector. To adequately address this issue, ASIC and the industry must work together to eradicate such behaviour and taking appropriate action against those who use such measures to stay in business.

Any responsible manager or director who has been involved in at least one insolvent licensee should have to show cause as to why they should be permitted to be a responsible manager or director of another licensee. While this would not automatically prohibit such persons from working within the industry, it would place the onus on them to demonstrate they are in fact a fit and proper person to act in the roles they are seeking.

Further measures to provide additional assurances should also be employed, such as such as enforceable undertaking as to future behaviour and compliance before they are permitted to act as a director or responsible manager of another licensed entity.

ASIC should also have the power to engage a liquidator to undertake an investigation of any licensee that has gone into liquidation. The liquidator should then have the ability to provide their recommendation to ASIC as to whether action should be taken against any officer of licensee.

Recommendation 2.5.1: Compensation where licensees cease to trade

In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business.

The Joint Accounting Bodies support the need to ensure there is a form of compensation arrangement to cover situations where a licensee ceases to trade. However, the hardening of the insurance market in this space coupled with only a handful of underwriters prepared to offer cover makes this difficult in reality.

We believe that ASIC should work with industry and the insurance industry to scope what alternate approaches could be adopted.

Recommendation 2.5.2: Protection from unlicensed providers

There are risks to consumers where they deal with financial services providers that:

- **have a licence, but operate beyond the scope of that licence because they provide products or services that are not covered by the licence; or**
- **should be licensed under the Corporations Act but are not, and accordingly have limited or no compensation arrangements.**

While acknowledging the difficulties in identifying outlaw activity, the importance of concerted enforcement effort by ASIC to police the boundaries of licensed financial service activities is emphasised. In its approach to the handling of complaints about outlaw activities ASIC should be transparent and provide as much feedback to complainants as possible in order to encourage further assistance.

While we appreciate the complex and ever evolving nature of the financial services sector, it is vitally important that ASIC maintains an effective oversight regime that keeps abreast of these developments. Consumers should have confidence that the financial service providers they engage are appropriately licensed to provide the services they are offering clients.

ASIC must devote sufficient resources to proactively identify and take action against unlicensed advisers. Recent compliance activity by the Australian Taxation Office and the Tax Practitioners Board has been effective in reducing the number of unregistered tax agents. We would encourage ASIC to work with industry to identify and take appropriate action against unlicensed advisers.

We support the continued marketing of MoneySmart and other proactive initiatives to assist consumers identify unlicensed advisers, including how they can check the *bone fides* of a purported adviser. We believe this should further extend to educating consumers what types of advice and services you must be licensed to provide.

Public education is also important an important tool to educate those sections of the community which may be more susceptible to unlicensed advisers. Such a campaign was successful in dealing with early access to superannuation fraud late last decade, as market intelligence identified that particular ethnic groups were being targeted due to their relative low understanding of Australia's financial system.

One of the hurdles in identifying unlicensed advisers can be the sense of shame and self-blame felt by some of those who have been defrauded by unlicensed advisers. This sense of shame and self-blame can prevent these victims from coming forward to identify perpetrators, which only further enables those perpetrators to continue to target vulnerable people. Victims of unlicensed advisers need to be encouraged to come forward and to do so at an early stage.

ASIC should consider further initiatives to encourage victims to come forward and identify unlicensed advisers. This process must strike a balance between ensuring the process for lodging complaints is simple and non-judgemental of the complainant, while affording procedural fairness to the alleged perpetrators.

Recommendation 2.5.3: Third party rights under licensee's insurance policy

(a) Where a licensee (or its administrator or liquidator) does not respond to claims from a consumer or the licensee cannot be contacted after reasonable inquiry, ASIC should be able to provide the consumer with information it has about the insurance policy including the name of the insurer and the policy number. This would assist the consumer to decide whether there is a prospect of recovering compensation should the claim proceed and be successful.

(b) The third party rights provisions of the *Insurance Contracts Act 1984* should be extended, as was proposed by a review of that Act in 2004, to apply where a consumer cannot recover compensation awarded against the insured and there is capacity to meet that liability from the insured licensee's professional indemnity insurance policy.

The Joint Accounting Bodies believe that not all matters can or should be automatically dealt with through legislation or regulation. Standards need to be set and enforced in relation to claims made by clients. Where a licensee does not act within those requirements the professional and industry bodies need to take action to enforce their requirements.

As a last resort and to deal with licensees who are not members of a professional or industry body, ASIC should be granted the power to inform a potential claimant the identity of the PI Insurer of a licensee.

Recommendation 2.5.4: Defence costs

ASIC should give further consideration, in its approach to the adequacy of professional indemnity insurance cover, to the treatment of defence costs with a view to striking a reasonable balance between the interests of licensees and insurers on the one hand, and consumers on the other.

The issue of defence costs should be addressed through the development of appropriate PI insurance standards for financial service providers as recommended in 2.1 above.

Any new obligations should only be mandated following agreement between ASIC, industry participants and the insurance industry.

Recommendation 2.5.5: External Dispute Resolution scheme processes

Given their key role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims. Issues for consideration include:

- **rights of review**
- **transparency**
- **capacity of a member to join in a proceeding other members that might be liable**
- **cost contribution by complainants; liability standards**
- **relevance of regulatory guidance and other operational issues discussed in Chapter 2.**

ASIC should convene a working group within the financial services industry, the EDR schemes and regulators to determine how the EDR schemes could be improved in order to provide a more effective mechanism to address client disputes.

The Joint Accounting Bodies support the notion that persons should only be held liable to the extent that they are responsible. While the client may only deal with the licensee (or their representative) the reality is that the provision of financial advice will invariably involve a number of participants. As such any review of the EDR process should look into how a member may join others involved in the provision of the advice and how proportionate liability could be introduced.

Any cost contribution by complainants must be minimal. The complexity of the complaint system will act as a natural barrier to frivolous or vexatious complaints. Even a small impost may cause some who would otherwise complain to decide not to, particularly where they have already suffered financial loss or are embarrassed about having incurred such losses.

3. Rebalance responsibilities of licensees

Recommendation 3.1: Review regulation of product issuers

As a matter of strategic approach, it would be timely to review the present relatively 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 be appropriate 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. A stronger approach by managed investment schemes to the management of risk of fraud, particularly by employees or representatives, might also be sought.

Product issuers have an obligation to ensure that their products are fit for market and are marketed to appropriate clients. While the adviser has the primary responsibility to act in their client's 'best interest', this does not remove all obligations on product issuers to ensure their products are suitable for the retail market. Licensees should be able to rely on the undertakings provided by product issuers as to the suitability of their products to different classes of clients. Furthermore, the law requires that any goods or service must be fit for the market.

The industry should develop appropriate classifications of clients as to their risk profile, investment appetite and other needs. Once such categorisations have been agreed, product issuers could be required to state whether or not their products are appropriate for such clients. Another potential solution would be a requirement that all products are rated for their suitability for different classes of consumers. Such ratings could be by an external rating agency, the regulator or self-assessed against industry standards.

(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.

The Joint Accounting Bodies would support consistent labelling of financial products. With the increase in accessing financial products online and the range of do-it-yourself options consistent labelling would provide a form of protection for consumers when making their investment decisions.

Standardised labelling could also potentially reduce complexity and confusion in the market place. Financial products can be confusing and the lack of industry standards only adds to the confusion that can lead to the situation where a product that is mislabelled is wrongly marketed. We therefore support industry and the regulator coming together to develop standardised product labelling.