Consumer Submission in response to the St John Report on Compensation Arrangements for Consumers of Financial Services

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Prepared with assistance from ASIC's Consumer Advisory Panel.

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1 About this submission

This submission on behalf of consumer organisations responds to the April 2012 report to the Commonwealth Government by Richard St. John, *Compensation arrangements for consumers of financial services* (the “Report”).

The St John Review was commissioned by the Minister for Financial Services, as part of the Future of Financial Advice ("FoFA") reforms, following a number of high profile collapses in the financial services sector. The purpose of the review was to evaluate the need for, and costs and benefits of, a statutory compensation scheme for consumers of financial services.

Consumer groups support many of the incremental changes recommended by the Report. This submission demonstrates however that the Report’s conclusion that a last resort compensation scheme ("LRS") is not currently warranted is faulty. The key point is that even if all the Report's recommendations for incremental change are successfully implemented, *there would continue to be a substantial number of consumers who are entitled to an award of compensation but who cannot recover that compensation.*

Without a LRS, consumers will continue to suffer extreme hardship through no fault of their own, the community will bear unnecessary social welfare costs, and confidence in the financial system and its regulation will continue to be undermined.

This submission describes the harm caused by unpaid compensation, in particular the impact on consumers, shows that a LRS would be the most cost effective response to the problem and considers each of the Report's recommendations. The executive summary includes a specific response to each recommendation.

The submission has been prepared in consultation with ASIC's Consumer Advisory Panel and the following consumer organisations and individuals:

- Australian Investor's Association
- Australian Shareholders' Association
- CHOICE
- Consumer Action Law Centre
- Consumer Credit Legal Centre NSW
- Financial Counselling Australia
- National Information Centre for Retirement Incomes (NICRI)

- David Coorey, Consumer representative FOS (Board)
- Stephen Duffield, Consumer representative FOS (Panel)
- Jenni Mack, Consumer representative FOS (Board)
- Justin Malbon, Consumer representative FOS (Panel)
- Denis Nelthorpe, Consumer representative FOS (Board)
- Paul O'Shea, Consumer representative FOS (Panel)

2 Executive summary

Australian consumers invest in financial services products to save for their retirement and build wealth. They seek advice from financial advisers and other licensees to help them assess suitable products with an appropriate level of risk. While consumers are ultimately responsible for their own investment decisions, they should be able to make those decisions without being affected by the misconduct of a product issuer or financial adviser.

The Corporations Act establishes a financial services regulatory system designed to protect consumers. Advisers and product issuers are required to be licensed. Consumers are entitled to an accessible forum for taking up complaints of misconduct with an external dispute resolution ("EDR") scheme. And consumers are entitled to be compensated where misconduct by a licensee causes them harm. Licensees must meet certain conditions in order to hold and maintain an Australian financial services ("AFS")

licence, including having sufficient financial resources and/or holding adequate professional indemnity (PI) insurance.

2.1 Failure of current arrangements and consequent harm

Unfortunately current arrangements do not adequately protect consumers. Every year a considerable number of consumers suffer significant financial loss caused by proven licensee misconduct. The typical scenarios in which consumers suffer loss are set out in section 3.5 below.

Since 1 January 2010, 22 members of the largest ASIC-approved EDR scheme, the Financial Ombudsman Service ("FOS"), have become insolvent. 234 claims amounting to nearly $63 million have been made against those providers. An unknown number of additional consumers suffer loss that is likely to have been caused by misconduct but do not pursue a claim in a court or EDR forum. A primary reason for not doing so is that the licensee is insolvent or missing and lacks adequate insurance. In those circumstances the cost of taking action is unjustified given the low chance of any compensation order being paid. Actuarial evidence provided to the St John review suggested that total losses may be in the order of $12 million per annum with average losses per consumer of around $65,000. The Report identified a more recent case where average losses were $95,000. The more recent FOS data suggests that *if* all claims made against members who became insolvent since 1 January 2010 are substantiated, unpaid claims could be closer to $25 million per annum, with no allowance for claims not presented to FOS due to a lack of any prospects for recovery. FOS data suggests average losses among current claimants may be as high as $120,000 each (see section 4.4 below).

A particular area of increasing concern relates to the recent rapid growth in the use of self managed superannuation funds ("SMSFs"), often with the encouragement of financial advisers, much of which has occurred after the consultations undertaken by Mr St John. This is important because, as demonstrated by the Trio case, investments made through SMSFs are much less likely to be covered by other compensation systems such as that operated under the *Superannuation Industry (Supervision) Act 1993* ("SIS Act"). The trend for superannuation savings to be invested through SMSFs will tend to increase the incidence of uncompensated loss in the near future.

Uncompensated investment losses create significant hardship for individuals and families. Section 4 of this submission sets out the nature of the hardship suffered by consumers, and provides a number of case studies. The Report confirms that there are a substantial number of consumers who suffer loss as a result of inappropriate or fraudulent financial advice (7.41) and that the consequences for individual consumers can be severe.

Uncompensated financial loss also affects the community and economy generally, with detrimental impacts on economic participation and increased reliance on social security,

health and welfare services. These impacts may in some cases be amplified where they are clustered in particular geographic regions (as the result of the activities of a particular licensee) and prevalent enough to have an impact on the local economy.

Uncompensated financial loss also results in reduced levels of respect for, and confidence in, the financial advice and investment industry.

Losses to individual consumers are demonstrably unfair vis-a-vis consumers who *are* compensated. Whether or not a particular consumer is compensated for loss and another is not is generally independent of any action taken by the consumer[1]. Relevant factors may include whether or not an adviser is sufficiently capitalised to remain solvent or is adequately insured to pay out claims. These causal factors are quite beyond the control of the consumer with the result that the harm is essentially randomly unfair.

It is important to bear in mind that the compensation arrangements contemplated and partially implemented by the Corporations Act are not intended to compensate for losses flowing from corporate failures or unlicensed dealing, nor for any losses that do not arise from misconduct (including breach of statutory obligation) by AFS licensees.

2.2 The need for a last resort compensation scheme

Consumer groups have advocated for the creation of a last resort compensation scheme ("LRS") over a number of years. A LRS is the only way to ensure that consumers who suffer loss from misconduct are compensated. It is effectively the missing piece of the financial services regulatory architecture. The absence of a LRS means Australia can be compared unfavourably for example to the system in the UK.

Any LRS would only be called on in a minority of cases – those where loss flows from proven misconduct by an AFS licensee, the licensee then cannot meet the claim (generally due to insolvency) and the consumer cannot be compensated by recourse to PI insurance arrangements.

In May 2012 the Report of the St John Review was published as *Compensation Arrangements for Consumers of Financial Services*. The Report concluded that a LRS should be considered in the future but that it should not be introduced until a number of other necessary reforms have been put in place.

Consumer groups agree that reforms of the kind recommended in the Report, designed to reduce the occurrence of uncompensated loss, are either required or should be

[1] In some cases consumers who make a complaint early may be more likely to receive compensation from a licensee who later becomes insolvent; however whether a consumer complains early or not, may depend on factors outside their control such as when losses come to their attention.

further considered. But implementing these changes will not avoid consumers being unfairly treated as a result of misconduct by licensees. The Report suggests only that these reforms would 'limit the instances' where consumers are not compensated. Moreover some consumers will, and some will not, continue to suffer uncompensated loss in broadly similar circumstances, an unfair result that will continue to discredit the financial services industry and the regulatory arrangements for the industry.

Consumer groups, however, see no benefit in delaying the introduction of a LRS and do not accept that any of the arguments put forward by the Report for delay in the introduction of a LRS are persuasive.

The primary reason advanced in the Report for delaying the introduction of a LRS is that doing so would create a kind of 'regulatory moral hazard' that would undermine the introduction of other necessary reforms including those recommended by the Report.

The Report provides no evidence or cogent reasoning to conclude that any such 'moral hazard' exists. There is no reason to think that the specific changes recommended by the Report – for example increased capital adequacy, modest reform to PI insurance requirements, and increased powers for ASIC to deal with unlicensed dealing – would not be introduced by Government at the same time as a LRS, if they were judged to pass a cost benefit analysis. It is hard to follow the Report's logic when it describes a LRS as "a shortcut means of remedying shortcomings in the current regime" where a LRS will be required even if those shortcomings are remedied.

The Report also recommends further exploration of less developed policy ideas such as the possible introduction of a suitability requirement on product issuers. Consumer groups support this recommendation. It would, however, be wrong to delay the introduction of required reforms now in order to further explore an idea that may or may not have merit, especially where it is clear that reform will only address a small part of the overall problem.

Equally significantly, the Report fails to note that rather than "moral hazard" the establishment of a LRS will create both an important constituency for effective reform and a mechanism to identify and perhaps implement reform. More responsible and better capitalised firms will want to ensure that the LRS is called on as rarely as possible and will thus have an incentive to advocate for systems that minimise misconduct. The LRS itself may have a role in monitoring and acting on problems that lead to claims on the scheme (see 5.5.1).

A LRS will also create an incentive for reputable and well capitalised AFS licensees to monitor the conduct of those licensees most likely to engage in misconduct and those most likely to fail, and where necessary report problems to the regulator.

The Report's recommendation against introducing a LRS until other reforms are in place is also influenced by concerns about the treatment of advisers in comparison to product issuers. It notes concerns that advisers are more likely to be the subject of compensation claims than product issuers. These concerns are misconceived as explained in detail at section 5.5.6. Compensation may only be awarded against an adviser where their proven misconduct has caused loss to a consumer. It is not at all surprising that claims to EDR schemes appear to more frequently relate to the misconduct of advisers rather than the misconduct of product issuers. The investment industry is structured to push consumers towards using advisers to be able to invest in certain products. The adviser has a much heavier responsibility to the consumer than the product issuer (in that the adviser must give appropriate advice), and is thus more likely to cause loss by wrongfully recommending inappropriately risky investments. There is a great deal of evidence that poor advice is widespread, much of it driven by conflicts of interest. While the recently enacted FoFA Reforms will remove many incentives for conflicted advice, some will remain.

We note that, despite these concerns, the Report is not opposed to a LRS in principle. Indeed, it gives considerable attention to the mechanics of how a scheme could work.

A LRS is the most cost effective response to the problem of uncompensated loss. It can be designed in such a way that costs to licensees (and thus consumers generally) are minimised and incentives for compliance and hence lower levels of claim are built into the scheme.

Finally we refer to the report of the Parliamentary Joint Committee on Corporations and Financial Services *Inquiry in to the Collapse of Trio Capital* May 2012. The Committee noted the St. John Report's recommendation against establishing a LRS but concluded that "if the policy objections raised by Mr St. John to the operation of such a scheme can be overcome, the Committee considers that it has merit and would have assisted to reduce the detriment suffered by innocent Australian investors in the Trio case".[2]

2.3 Setting a future date for the introduction of a LRS

Consumer groups do not support the conclusion that a LRS should be considered only at a future time. If, however, government was minded to first introduce the specific actionable recommendations of the Report, then it should also set a deadline for the introduction of a LRS. The most effective way to do this would be to enact the legislation required to underpin a LRS at the same time as introducing the changes to capital adequacy requirements, PI insurance and regulator powers recommended in the Report. The legislation would specify a start date for the LRS two or three years after the legislation is passed.

[2] Parliamentary Joint Committee on Corporations and Financial Services *Inquiry into the collapse of Trio Capital* May 2012 at xix.

2.4 The Report's specific recommendations to reduce the number of uncompensated consumers

As noted above, the Report makes a number of specific recommendations designed to reduce the number of unmet compensation claims.

Consumer groups support most of those changes. Our specific responses are set out in the Table at Section 2.8 of this Report below and further elaborated in the sections of the submission indicated in the Table.

2.5 Operation of a LRS

The Report discusses how any LRS might operate. It recommends that the LRS use a different standard of licensee liability than that currently used by the EDR schemes. As a consequence the LRS will be required to reconsider each and every compensation award made by a court or EDR scheme. Consumer groups do not support these recommendations.

The aim of any LRS is to ensure that consumers receive at least some compensation when they are found to be entitled to an award by an EDR scheme or court. To suggest that the LRS should introduce fine distinctions between consumers who have successfully won an award undermines the purpose of a LRS. It will add considerably to the cost of the scheme, increase delays and undermine its credibility in the same way as current unjustified distinctions between consumers who do and don't receive compensation.

Further discussion of this recommendation and the Report's other recommendations about the operation of a LRS are set out below at 5.9.

2.6 Is there a need for additional review of the details of the EDR schemes?

Consumer groups strongly disagree with the Report that there is a particular need for ASIC or Parliament to re-examine certain features of the operation of EDR schemes in the financial services sector.

The Report raises a number of questions about the operation of EDR schemes such as FOS, including whether or not complainants should be required to pay a fee and whether the EDR schemes' rules should allow for appeals against decisions. The kind of changes contemplated by the Report would be inconsistent with the principles of accessibility, independence, fairness, efficiency and effectiveness underpinning the

schemes. Moreover, whatever the merits of those changes, they will do nothing to assist in the resolution of the problem of consumers who are not compensated for losses, where a licensee is found to have caused loss through misconduct and is then unable to pay the awarded compensatory sum either from their own resources or through their PI insurance.

2.7 Proportionate liability between product issuers and advisers

The Report further recommends that EDR schemes be enabled to join product issuers where an adviser is the subject of a complaint, and to apportion liability between an adviser and issuer where appropriate. In our view there is no case for this recommendation. There is no evidence that advisers are being called upon to pay compensation where the loss is not caused by their misconduct. Advisers stand in a very different relationship to consumers than do issuers. Consumers expect their financial adviser to assist them to identify suitable products with appropriate risk levels. In any case apportionment of fault and liability between product issuers and advisors has little impact on the substantive issue of adequacy of compensation for consumers. Issues around apportionment should be treated with caution lest they be given undue emphasis and inadvertently detract from the rather larger social and economic problems caused by the devastating consequences of uncompensated loss to consumers.

2.8 Summary of consumer representatives' responses to the Report's recommendations

Recom-mendation	Topic	Consumer Response	Discussed in this submission at …
1	Not to introduce a Last Resort Scheme at this stage	Strongly opposed	5.5
2.1	Adequacy of insurance	Strongly supported	5.3
2.2	Appropriate capital requirements	Strongly supported	5.2
2.3	A more proactive stance by ASIC	Supported	No discussion
2.4	Policing the licensing system	Supported	5.4
2.5.1	Compensation where licensees cease to trade	Supported	5.4
2.5.2	Protection from unlicensed providers	Supported	5.5.5
2.5.3	Third party (consumer)	Strongly supported	5.3

	rights under licensee's insurance policies		
2.5.4	Defence costs	Not particularly supported	No discussion
2.5.5	EDR Scheme processes	Strongly opposed	5.10
3.1	Review regulation of product issuers	Supported	5.6
3.2	Responsibility of product issuers in EDR schemes	Strongly opposed	5.11

3 Introduction to the problem

3.1 Investment losses that should be compensated

Consumers suffer a range of investment related losses. Compensation is not, and generally should not be, available for losses that flow from the ordinary risks that consumers take when they make investment choices (for example a market downturn). Consumers may, for example, choose to put some of their funds in a high-risk investment. If they lose money as a result of identified risks coming to pass, they should not be entitled to compensation. Those risks include the risk of corporate failure.

However some consumer losses do not flow from the ordinary risks of investing. Instead, they flow from the misconduct by a product issuer or financial adviser. Consumers are entitled to compensation for losses that are caused by breaches of the financial services laws under the Corporations Act, including breaches of the obligations to provide appropriate advice, and not to engage in dishonest or misleading or deceptive conduct.[3]

3.2 Legislative policy to ensure consumers are compensated

The policy underlying the current regulation of the financial services industry seeks to provide for consumer compensation where they have suffered loss as a result of a breach of statutory requirements designed to prevent misconduct by a licensed financial service provider.

3 See the following sections of the Corporations Act 2001: s 912A General obligations; s 912B Compensation arrangements if financial services provided to persons as retail clients; 1041E False or misleading statements; 1041F Inducing persons to deal; 1041G Dishonest conduct; 1041H Misleading or deceptive conduct (civil liability only); 1041I Civil action for loss or damage for contravention of sections 1041E to 1041H; 1041J Sections of this Division have effect independently of each other; 1041K Division applies to certain conduct to the exclusion of State Fair Trading Acts provisions.

The Corporations Act seeks to provide consumers with the benefits of compensation in those circumstances through two key provisions:

1. EDR scheme requirements: licensed financial service providers are required to belong to an ASIC-approved EDR scheme (pursuant to s 912A Corporations Act 2001 and as a condition of their licence) to ensure that consumers have effective access to a mechanism to have disputes with financial services licensees resolved. EDR is intended to be a cheaper, quicker and more consumer-friendly alternative to going to court, which was and remains inaccessible for most consumers who have grounds for complaints against a financial services licensee. For a number of reasons set out later in this submission, previous arrangements which required consumers to litigate matters in court meant that, in practice, very few claims were in fact made and consumers were unable to recover their losses. While the operation of EDR schemes greatly improves consumer access to dispute resolution, significant barriers remain[4] and as a result many consumers do not have their disputes resolved.

2. Compensation arrangements: AFS licensees are also required to establish compensation arrangements (s912B)[5]. Currently, this means that, in practice, licensees providing investment advice or investment products directly either self-insure (many prudentially regulated licensees) or take out PI insurance to cover claims made against them. Where a PI insurance policy is required, it must comply with Corporations Reg 7.5.02AAA and ASIC Regulatory Guide 126,[6] which sets out the minimum requirements a PI insurance policy must meet to be 'adequate'.

3.3 Current arrangements do not effectively implement the policy

[4] 'ASIC Report 240 found that a number of consumers may not complain, even if they may have a legitimate claim. This is because of feelings of self-blame/embarrassment.
Even if consumers do complain, the existing jurisdictions of the schemes may mean that the scheme cannot assist them (e.g. because the value of their claim exceeds $500,000 or because the licensee has become insolvent).

5 Corporations Act 2001, s912B

Compensation arrangements if financial services provided to persons as retail clients

(1) If a financial services licensee provides a financial service to persons as retail clients, the licensee must have arrangements for compensating those persons for loss or damage suffered because of breaches of the relevant obligations under this Chapter by the licensee or its representatives. The arrangements must meet the requirements of subsection (2).

(2) The arrangements must:

(a) if the regulations specify requirements that are applicable to all arrangements, or to arrangements of that kind--satisfy those requirements; or

(b) be approved in writing by ASIC.

(3) Before approving arrangements under paragraph (2)(b), ASIC must have regard to:

(a) the financial services covered by the licence; and

(b) whether the arrangements will continue to cover persons after the licensee ceases carrying on the business of providing financial services, and the length of time for which that cover will continue; and

(c) any other matters that are prescribed by regulations made for the purposes of this paragraph.

(4) Regulations made for the purposes of paragraph (3)(c) may, in particular, prescribe additional details.

[6] ASIC Regulatory Guide 126 “Compensation and insurance arrangements for AFS licensees” December 2010 http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg126-20Dec2010.pdf/$file/rg126-20Dec2010.pdf.

It is widely acknowledged, including by the Report, that current requirements for compensation arrangements (that is Corporations Act s912B) do not achieve the desired policy end of providing for compensation in all relevant cases[7].

It is not uncommon for a consumer to be found to be entitled to compensation after pursuing a complaint through EDR, but be unable to actually obtain that compensation, because the "compensation arrangements" fail. Structural weaknesses mean that PI insurance is not fully effective for consumers in cases where a licensee is insolvent, and the licensee is unable to claim on its PI insurance policy, for example because coverage was too limited, the licensee was in breach of an important term of the contract or the licensee failed to notify the insurer in time. Note that AFS licensees are generally unable to obtain 'run off' cover and so claims can be denied where they are made after the period of insurance.

3.4 Current arrangements unfairly distinguish between investment types and investment vehicles

The situation in relation to investment advice can be contrasted with other categories of AFS licensees where there is a range of measures which enable consumers to be compensated and thus ensure that consumers will generally not suffer catastrophic loss. In particular, there are 'last resort' compensation schemes that apply to investments made through APRA regulated superannuation funds, deposits with authorised deposit-taking institutions (ADIs) and stockbrokers.

However, there is no LRS in operation in relation to non-APRA-regulated investments. The collapse of Trio Capital well illustrated the unfairness inherent in the financial services sector. Of the investors who suffered losses, 5,400 of those with APRA-regulated investments were able to recover full compensation. However there were around 690 investors (285 investing through SMSFs) who were not eligible for compensation through this source. Some of these obtained compensation in other ways, for example through court action against an adviser[8]. Without the introduction of a LRS, it is not possible to ensure that all consumers who are awarded compensation by a courts or an EDR scheme will receive it.

3.5 Uncompensated losses occur in several predictable sets of circumstances

In the absence of a LRS, a deserving consumer facing catastrophic loss may not be compensated. The most common scenario where a consumer is likely to find themselves in this situation, through no fault of their own, occurs where each of the following conditions is met:

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[7] Report at 2.148.

[8] At least one investor is reported to have obtained a $1 million compensation court award against her adviser for negligence/breach of fiduciary duty/inappropriate advice, see: http://www.investordaily.com.au/14425.htm.

- the consumer has relied on the advice of a licensed financial services provider; *and*
- that advice has been found by a court or an EDR scheme to be negligent, fraudulent or otherwise inappropriate such that the consumer ought to be compensated; *and*
- the licensee has not paid the amount awarded in compensation (for example because they are insolvent); *and*
- the consumer is not able to recover the amount awarded to them under the licensee's professional indemnity policy.

A second scenario leading to loss is somewhat less common, but when it does occur it usually affects a large number of investors. In such cases:

- a non-APRA regulated product issuer offers a high risk product directly to investors; *and*
- the product breaches its statutory obligations (typically by misleading investors about the risk/ reward relationship); *and*
- consumers relying on the misleading promotion suffer investment losses; *and*
- the product issuer becomes insolvent.

In this scenario PI insurance is not relevant. The ACR case is an example of a high-risk product where consumers suffered loss, many having relied on promotional material that was in all likelihood misleading[9].

The third scenario combines elements of the first two. One or more advisers are involved. They recommend a particular risky or unsuitable product to a larger group of clients. Often they provide highly conflicted advice based on incentives offered by the product issuer. The product does not provide the returns promised and the product issuer fails. Consumers make claims against the adviser for providing inappropriate or negligent advice. Where those claims are successful the adviser is unable to pay, and the adviser's PI insurance is unavailable for one of the several possible reasons referred to above.

Loss flowing from poor advice is not uncommon. This is not surprising given the prevalence of financial advice that does not meet standards of good practice as documented from time to time in shadow shops of financial advisers[10]. It is surprising that the Report does not particularly acknowledge either the greater responsibility of advisers in protecting their client's interest nor the role of poor advice in leading to

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[9] ACR was declared insolvent and there has been no point making a compensation claim. As a result, so as far as we are aware, there has been no finding of misconduct.

[10] The recently published findings of ASIC Report 279 *Shadow shopping study of retirement advice* are discussed at section 5.5.6 below.

consumer harm in cases including those where the product issuer fails. The varying responsibilities of advisers and issuers are discussed in more detail at 5.5.6 below.

4 The harm caused by uncompensated loss

4.1 Harm to individual consumers and their families

Uncompensated financial losses arising from licensee misconduct cause a range of financial and non-financial losses. They impact on the affected consumer and their family, the community generally and the financial services industry. This section describes the nature of that harm.

The impact of uncompensated loss was the subject of research commissioned by ASIC's Consumer Advisory Panel and reported in Susan Bell Research, *Compensation for retail investors: the social impact of monetary loss*, ASIC Report 240, May 2011.

The Bell research reported on the experiences of 29 consumers affected by losses. For 17% of the sample group, the impact of uncompensated loss was immediate and catastrophic. These consumers were living below the poverty line and had either lost their home or were perilously close to losing it. They were in serious debt. One lived in a caravan, another in their car. All were in ill health, or became ill afterwards. Most felt deeply ashamed of their poverty and had to rely on charity. They had been diagnosed as suffering from high levels of ongoing stress and/or a range of other illnesses associated with stress which were not problems before their loss.

For a further 27%, the impact was more constrained financial circumstances and a significant decline in living standards to the point where they were now “living frugally”. Many suffered from long-term depression. They had to cut down on expenditure on clothes, entertainment and holidays. Some began to supplement income by collecting cans and delivering newspapers. Many had ongoing stress, anxiety or depression and related illnesses, especially if there were debts to repay.

The losses caused damage to family relationships and caused people to withdraw socially from friends and family. Some were forced to take on additional jobs, others were forced back into the workforce. Emotional impacts included anger, confusion, blame, depression, uncertainty, stress and shame.

A number of case studies of consumers affected by uncompensated loss are included in this submission. Case studies 1 and 2 in this section and case study 4 in section 5.2 below include material about the impact of the loss on the affected consumer.

Welfare Rights Centres provide legal advice to individuals in relation to their social security entitlements, including those who seek social security following investment losses, some of which flow from uncompensated loss caused by an adviser's misconduct. Maree O'Halloran, President of the National Welfare Rights Network (NWRN) has provided her views on the impacts of uncompensated loss as follows:

> *Consumers need to be able to access compensation for losses incurred as a result of negligent financial advice or misconduct on the part of financial advisors. Otherwise, both the individual affected and the public generally ends up paying for the loss of the capital invested.*
>
> *The NWRN has seen the effect on people who have suffered investment losses. Many people, previously self-funded retirees, have to rely on the Age Pension. Others, who were receiving a part-pension, become fully reliant on the pension. Many people are dealing with Centrelink for the first time in circumstances marred by financial and emotional crisis. Added to this, people are trying to understand the complexities of the income, assets and deeming rules in the Social Security Act and are often not well placed to understand whether decisions made by Centrelink are correct. These outcomes are particularly harsh when the investment loss arises from an advisor's negligence or misconduct.* [11]

The seriousness of the impact of uncompensated loss on consumers was acknowledged in the Report. The Report cited ASIC Report 240:

> *"For consumers who lost all their money and/or incurred debt, the financial impact of the loss was 'immediate and critical' and even 'catastrophic' and 'so significant their life will never be the same'. The impact on affected individuals included the loss of the family home, illness, strain in family relationships, and frugal spending on essentials. The study found the emotional wellbeing of affected consumers deteriorated with 'prolonged anger, uncertainty, worry and depression'. The study also found a subsequent lack of confidence in the financial system by those experiencing the loss.* [12]

The Report concluded "while the shortfall may not appear great overall, there is no denying the potential seriousness of the consequences for individual consumers who miss out on compensation to which they are entitled. There could be a consequential impact on the confidence of those consumers in financial services". [13]

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[11] Personal communication, June 2012.
[12] Report 2.165 to 2.166.
[13] Report p 49.

Case Study 1: Couple, 55–64, Regional Queensland[14]

The couple was advised to invest in a particular scheme by their financial adviser. They were impressed with the apparent endorsement of the scheme by politicians.

On the adviser's advice, they sold their house and invested the proceeds, some into the particular scheme and the rest into other similar schemes. The money was "*parked*" there while they looked for another house. They expected to be self-funded retirees.

In 2007, they started seeing articles in the press about the scheme. Before the fund failed, the adviser reassured them there was no problem with it. Then the scheme owners wrote to them to tell them their investment had all gone. At that point they were feeling "*worried*, *nervous, jittery, anxious*".

Then they heard from their adviser "*saying that they had lost some sort of insurance cover, whatever cover the financial adviser must have.*" The adviser was subsequently deregistered.

By then, their only income was $50 a week out of the super fund but they had a $400 dollar a week rental. They could not move to another cheaper rental because "*people could see we were unemployed, had no income*". So they broke their lease and lived in the car "*out west*" on campsites for a while. This was in 2008 – it took about a year to get to this point. Over this period, the stress reignited a mental health problem, so the husband had to see a psychiatrist and was diagnosed with depression.

Then things got a bit better. He started getting a Defence Department pension and they were able to get a loan to buy a house that someone else was selling very cheaply because they too were in trouble. They still have some super. They are healthy "*because we walk everywhere*" (having sold the car). One of them has a casual job and the other volunteers somewhere.

They describe themselves as "*thrifty*". They don't eat out. They buy the cheapest of everything. They don't visit friends and family any more.

At the beginning of 2009, the husband wrote to ASIC asking for compensation because the adviser did not point out the negative consequences of the advised investments. ASIC responded in mid 2010 saying that they would not take any action. ASIC suggested that they take legal action – but as he understands it, that is impossible for people who have lost everything and have no money.

It has taken about 18 months of trying to get compensation of some kind. His wife says he spends "*95% of his time is on the computer, writing, receiving, following up,*

[14] ASIC Report 240 p 56.

and researching any lines of possible action that he can take." Their marriage is under strain and his health is no better.

As time has gone by the initial stress has turned into anger. He was fighting the system.

They blame the government, because the scheme was 'not accountable', and the adviser, because the recommended scheme was paying commissions to the adviser.

Case study 2: NICRI caller - impact of fraud and delay[15]

A caller's funds were placed into and periodically switched around high-risk investments, which he said he was not comfortable with nor had approved, subsequently reducing his value significantly. His funds from this investment are now in a cash investment (with the losses crystallised).

He was told by the applicable EDR scheme that a decision (on the adviser's liability for compensation) would not be made until after the outcome of the police investigation into illegal activity by the adviser, and that this may take several years.

This has meant that the caller will have little funds to live on for rest of his retirement. It is unclear the extent of the illegal activity.

He is distressed knowing he may not be able to maintain the lifestyle he was expecting and will need support to live adequately. It seems that after exhausting all available avenues, and with little in other resources to take legal action, he has nowhere else to go. As the caller is 76 there is little prospect of him working to replace the funds and with a life expectancy of approximately 10 years there may be little time to utilise any funds if a settlement takes several years.

4.2 Impact on government and community resources

Several sources including the Report recognise that affected consumers draw more on community resources than would otherwise be the case.

The Report notes that:

> *[t]here is also a flow on cost to the community as a whole, with some cost transferred to governments, the financial system, the charitable sector, and the corporate sector more broadly. For example, individuals who had invested to fund their retirement may have to turn to the age pension following their loss".*[16]

[15] Information provided by NICRI, June 2012.
[16] Report 2.165 to 2.166.

ASIC Report 240 also identified significant costs to the community, with people turning to charities and Centrelink for assistance for the first time. Given the onset of illness and depression, it seems reasonable to assume there would also have been an increase in reliance on health care services.

And Maree O'Halloran of the National Welfare Rights Network has advised us as follows:

> *The NWRN has also observed that the cost to the public purse includes not only the increased pension payments, but also the cost to administer and review those payment arrangements. It follows that additional costs to State and Commonwealth Governments and the welfare sector are incurred to deal with the associated problems such as housing (including increased reliance on public housing and Rent Assistance), health (including social work intervention and costs of medical treatment for illnesses associated with the stress of financial displacement) and increased reliance on legal services (including from the community legal sector and Legal Aid)*[17].

These costs are ultimately borne by the Australian taxpayer.

4.3 Loss of confidence in the financial services industry and its oversight

The prevalence and notoriety of losses arising from licensee misconduct decreases confidence in the financial system and the financial services industry. That lack of confidence is compounded where, despite having demonstrated loss resulting from inappropriate conduct, consumers are not compensated– generally because the licensee is insolvent and the loss is not covered by the licensee's PI insurance policy.[18]

ASIC Report 240 found that "one of the most significant impacts of these investor's losses is the damage to their confidence in the financial system".[19] It also found that confidence in ASIC was shaken and most of the blame was leveled at financial planners and some banks.

ASIC Report 240 also documented a loss of confidence in the sector and with the regulator and Government.

The absence of effective compensation arrangements under s912B of the Corporations law is undermining the otherwise very effective operation of the provisions of s912A(1)(g) and (2).

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17 Personal communication, June 2012.

18 S. Bell *Compensation for retail investors: the social impact of monetary loss Report* 240, 19 May 2011.

19 S. Bell at p 49.

Loss of confidence also appears to extend to the EDR schemes, potentially undermining their effectiveness. Case study 3 describes a common scenario at FOS based on consumer representatives' experiences.

Case study 3: loss of confidence in EDR schemes

Many financial planning complaints that come to a FOS Panel take at least 18 months to finalise and necessarily involve an arduous process of document exchange and commentary. While stressful for both parties, for consumers it can easily come to dominate every aspect of their daily life, given the ongoing ramifications of meeting financial commitments arising from what is now, a disputed plan.

In addition, while a consumer does not pay a 'fee' in respect of claim lodgement, there is a 'price' to be paid in respect of responding to FOS' ongoing requests for information or comment - files may end up running to many hundreds of pages.

At the culmination of this challenging experience the consumer may be awarded compensation only to be told the AFS licensee is now in liquidation and the PI insurance policy is not responding with the result that compensation will not be paid. The consumer will be left devastated and will ask the valid question: what was the point in engaging in the whole exercise? If EDR and the regulatory framework are powerless to enforce payment pursuant to a binding decision, then why would a consumer embark on this arduous course? Arguably, such valid concerns undermine the basic integrity of the EDR process, if not the entire regulatory apparatus.

4.4 Extent of uncompensated loss

The Report sought information about the number of claims for and average amount of uncompensated loss. Comprehensive data about the existence of such matters or the quantum of loss is not readily collected or easily available. It is likely to be particularly difficult to obtain accurate data about loss in cases where consumers conclude rightly or wrongly that investing time and money to pursue a claim against an insolvent adviser or product issuer would not be worthwhile. The Report does consider an estimate of $12 million per annum compiled by actuaries briefed by FOS at an average amount per claim of $65,000[20]. It finds that while there is considerable margin for error in that estimate on both the upside and downside (paragraphs 2.158-2.161) that these estimates provide a sense of the scale of uncompensated loss.

[20] The report notes that in one more recent case of the insolvency of a product issuer the average claim was $91,000 (paragraph 2.160).

FOS – the largest ASIC approved EDR scheme – has subsequently advised that from 1 January 2010 until July 2012, 22 of its members became insolvent. 234 claims amounting to nearly $63 million have been made against those providers. Only 20 of these claims have so far been resolved with just over $2.4 million awarded to those consumers but unpaid and unlikely to be paid (an average of around $120,000 each). This information was not available at the time the St. John Review consulted with FOS in 2011.

An unknown number of additional consumers suffer loss that is likely to have been caused by misconduct but do not pursue a claim in a court or EDR forum. A primary reason for not doing so is that the licensee is insolvent or missing and lacks adequate insurance. In those circumstances the cost of taking action is unjustified given the low chance of any compensation order being paid.

Actuarial evidence provided to the St John review suggested that total losses may be in the order of $12 million per annum with average losses per consumer of around $65,000. The more recent FOS data suggests that *if all claims were upheld* losses could be closer to $25 million per annum[21] with average losses of $120,000 each. This amount makes no allowance for claims not presented to FOS due to a lack of any prospects for recovery.

Consumer representatives are concerned that the scale of uncompensated loss will increase in the future. As noted in discussion of the Parliamentary Joint Committee on Corporations and Financial Services *Inquiry in to the Collapse of Trio Capital* May 2012 report at 5.5.6 below, under current arrangements losses in investments made in or through an APRA regulated superannuation fund are much more likely to be compensated than investments through a SMSF. More and more of Australian's superannuation savings is moving to non-APRA investments, often on the advice of financial advisers. The number of SMSFs in Australia nearly doubled in the past year[22]. The Final Report of the *Parliamentary Joint Committee on Corporations and Financial Services* (PJC)'s Inquiry into the collapse of Trio Capital (May 2012) found that:

- 30% of the total $1.34 trillion of Australian super assets are held by SMSFs;
- Australians who start up SMSFs are not aware that they are taking themselves outside the protections of APRA-regulated super funds; and
- SMSFs who invested in Trio set up the SMSF because they were advised to do so by their accountant or financial adviser and did not really understand them.

The Australian Shareholders Association reports that it is receiving an increasing numbers of calls from investors who have set up an SMSF based on the advice of a financial planner or stockbroker[23]. The PJC also noted its concern that many Trio

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[21] Data provided by FOS, July 2012. $25 million per annum based on $63 million over 2.5 years.

[22] According to Dec 2011 ATO statistics, there are 458,561 self-managed super funds (SMSFs) with a total of 873,903 members which represents a very significant increase in SMSFs in 12 months.

[23] Personal communications Vas Kolesnikoff, Chief Executive Officer, Australian Shareholders' Association.

investors were unaware that they had, at their adviser's instigation, established SMSFs and the implications of doing so[24]. Recent research by Russell Investments and the SMSF Professionals Association of Australia has found that approximately 14% of Generation X (31-45 years) and 10% of Generation Y are looking to establish a SMSF in the next 2 years. The reasons for doing this are to 'have full control of my life savings and investments' yet in reality they are handing control to financial advisers and accountants who will administer the funds on their behalf.

5 Potential policy responses

5.1 Multi-pronged response required

As described above (section 3.4.1), consumers remain uncompensated when a number of conditions are met. It makes sense to address each of the underlying causes that contribute to the problem to avoid losses occurring in the first place, to increase the capacity of licensees to meet their obligations to pay compensation awards and to increase the ability of insurance to cover situations where they cannot.

No one suggests that policy responses of this sort will cover all situations, and thus implementing them will not obviate the need for a LRS. Implementing the measures will however very likely reduce the number of matters for which a LRS will need to be drawn on, the funds required to pay uncompensated consumers, and thus the levy imposed on industry participants to contribute to the scheme.

5.2 Capital adequacy

The Report recognised that some AFS licensees have become insolvent where they had low capital bases and were thus vulnerable to unexpected liabilities including liabilities to consumers for losses flowing from their misconduct.

The Report recommends:

> *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.*[25]

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[24] "The committee is concerned that some SMSF investors in Trio Capital seemed not only unaware that their investment was unprotected from theft and fraud, but unaware they had even established a self-managed fund. The committee considers that this highlights the need to improve financial literacy for those considering SMSFs. Similarly, there is a responsibility for accountants and financial advisers to better educate their SMSF clients and clearly communicate the risks and advantages of investing through these vehicles." (Xxiv – xxv).

[25] Report Recommendation 2.2 p 147.

Consumer groups support this recommendation. The Report is right to conclude that capital adequacy requirements should ensure AFS licensees have some buffer and 'skin in the game' in relation to the impact of compensation claims on their solvency.

Among other things this recommendation, if implemented, is likely to force out of the market firms that are too small to meet the new capital adequacy standard. Experience to date suggests that more substantial firms have managed their affairs well, even in the aftermath of the global financial crisis when retail clients were more inclined to lodge complaints to FOS (and its predecessor scheme the Financial Industry Complaints Service – FICS) as the fallout from the GFC started to impact on their investment strategies[26]. Larger, better-capitalised firms can more comfortably accommodate a number of adverse FOS panel determinations. Of course this does not mean that smaller firms should not be supported, provided they have the resources and/or insurance to compensate consumers. Obviously amalgamation should not be supported for its own sake or where there is a risk to competition and thus potentially to affordability of advice.

5.3 Professional indemnity insurance

The absence of adequate PI insurance was earlier identified as a contributing factor to uncompensated loss, generally in relation to loss caused by the misconduct of a financial adviser. Case study 4 illustrates the problem of a consumer pursuing an adviser for misconduct in the absence of run-off cover; case studies 5 and 6 provide examples of other problems that consumers have faced relying on PI insurance to pursue claims against licensees.

Case study 4: Run off cover not included as standard

The following case study, concerning caller to NICRI, illustrates the problem with PI insurance and the absence of standard run off cover.

An elderly caller was advised to use the proceeds from a reverse mortgage to invest in a tea plantation managed investment scheme and so called 'blue chip' shares. She was given sketchy information with little detail of either investment. The tea plantation investment has since failed and the 'blue chip' shares are unaccounted for.

The adviser appears to have been declared bankrupt and is not contactable. FOS is currently investigating her claim but she has little expectation of receiving any compensation even if they make an award in her favour, because of the bankruptcy and there being no run off cover with the adviser's PI insurance policy.

[26] Personal communication, Stephen Duffield, July 2012.

The reverse mortgage is still in place and the debt is compounding. She is now suffering from depression and financial stress with little she can do. She is reluctant to name names and/or send any details to NICRI as she feels ashamed and thinks that it will only create more stress.[27]

This consumer was also unable to find out the details of the adviser's PI insurer.

Case Study 5: PI insurer contests claim

155 consumers invested a total of $2.8 million in a scheme. In attempting to recover a portion of this money, action [had] been taken against the management company, which has a PI insurance policy. However the PI insurer has denied liability on the grounds of material non-disclosure. The Chairman of the management company has no assets but the company is not insolvent. In this situation the consumers are relying on the Chairman to cross-claim against his PI insurers, a matter that does not appear to be a priority for him. In this case the Chairman has a valid claim against the insurer under s54 of the Insurance Contracts Act.[28]

Case Study 6: Licensee in breach of terms of PI insurance policy

The misconduct occurred in 1998/1999. The client complained to the investment adviser in February 2000. The client saw a lawyer in June 2000. The AFS licensee notified the insurer in October 2000. The client filed a claim in December 2000. The insurer denied liability on the basis of a material non-disclosure in that the licensee failed to tell the insurer that its AFS licence to deal in securities had been cancelled in May 2000.[29]

5.3.1 Reforms needed to PI insurance arrangements

Consumer representatives recognise the need to improve the operation of existing PI insurance arrangements.

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[27] Case study provided by NICRI June 2012.

[28] J Mack and C Connelly *Financial Services Consumer Policy Centre: Review of Compensation Arrangements Consumer Submission November* 2002 http://archive.treasury.gov.au/contentitem.asp?NavId=066&ContentID=480.

[29] J Mack and C Connelly *Review of Compensation Arrangements.*

While we support the recommendations of the Report to this end, they are not likely by themselves or in combination with the Report's other recommendations to make a large impact on the number of uncompensated consumers. To do so would require the kind of wholesale reforms to PI insurance arrangements recommended by the Financial Services Consumer Policy Centre in 2002. Unfortunately many of those broader recommendations have proved difficult to implement.

5.3.2 The Report's recommendations on PI insurance

The Report recommends that:

(1) ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate PI insurance cover and any new requirement in regard to financial resources, and in targeting AFS licensees who are most at risk. (Recommendation 2.3)

and that (2):

> (a) Where a licensee (or liquidator/administrator) does not respond or is uncontactable, 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 PI insurance policy. (Recommendation 2.5.3)

Consumer representatives support both recommendations.

5.3.3 Further reforms to PI insurance would be required for it to be effective

The following recommendations made by the Financial Services Consumer Policy Centre (FSCPC) in 2002[30] remain unimplemented and are not recommended by the Report. If the bulk of these recommendations were fully operational in addition to the Report's recommendations, there would be a greater prospect of PI insurance playing a major role in ensuring consumers entitled to an award actually receive compensation. Even then, there would be gaps as some consumers who are promised compensation by the Corporations Act would remain uncompensated. Of course if these changes to PI insurance were in place then PI insurance will certainly become more expensive. There

[30] J Mack and C Connelly *Review of Compensation Arrangements.* This list does not include those recommendations that have been implemented or are broadly similar to those recommended by the Report.

is also no guarantee that PI insurers would actually offer products that met these criteria. As a result, a LRS would seem to be a cheaper, more effective and more comprehensive response to the problem.

Selected recommendations made by FSCPC with our comments are as follows:

FSCPC 2002 Recommendation	Consumer Group Comment
Licensees should be required to include the name of their PI insurer and the terms of the contract - at least up to the regulatory requirements - in their Financial Services Guide.	Continue to support
Minimum PI insurance requirements should include non-avoidance clauses for innocent and fraudulent non-disclosure and non-notification. This is consistent with Insurance (Agents and Brokers) Act ("I(AB)A") and will end legal uncertainty.	Continue to support
Minimum PI insurance requirements should include clear coverage of dishonesty and fraud.	Comment: to provide fraud cover may push up PI insurance costs to levels too high to sustain. This is why a LRS would be a more efficient policy solution.
PI insurance policies must be deemed current for the full year irrespective of the funding arrangements.	Continue to support
In addition to the I(AB)A requirements mandatory PI insurance should include: • Endorsement of EDR determinations • Coverage of Trade Practice Act, ASIC Act and Corporations Act breaches • Unambiguous fraud and fidelity cover.	Continue to support except in relation to fraud cover - see comments above. Again we accept that this is very likely to make policies unaffordable, hence a LRS is the more cost effective policy response.
In mandating minimum PI insurance requirements, the Government should encourage professional associations to work with insurers to obtain group insurance.	Comment**:** Ten years of experience since these recommendations were made suggest that mandatory cover will be difficult to achieve again demonstrating why a LRS is the more efficient and effective policy response.
If the PI insurance industry is unwilling or unable to provide appropriate insurance for AFS licensees then the Government should consider organising a scheme for the licensees.	Comment**:** refer previous comment. Government appears to have little appetite for these types of interventions.
Mandatory PI insurance minimums must have	Comment**:** We understand that ASIC

a general requirement for run-off cover however the detail should be settled by ASIC on a sector-by-sector basis.	more recently explored such a requirement through Regulatory Guide 126, however found that PI insurers were unable to offer such cover. In the absence of insurers/reinsurer willingness to offer such cover it seems difficult to see how this could be achieved. However in the absence of run off cover PI insurance is of very limited value to consumers to protect them from the insolvency of an adviser guilty of repeated instances of misconduct.

Another important reform required for PII to be effective is to change the way excesses are applied to licensee's insurance policies. We understand that in the Westpoint case insurers applied an excess (typically $5,000) on a per claim basis rather than per event basis. Some small advisers were hit with excess payments to insurers of over $1 million and it was this that put them into bankruptcy.

5.3.4 Improvements to PI insurance will not solve all uncompensated loss problems

The reforms recommended by the Report would somewhat increase the prospect of a consumer having their entitlement to compensation met by PI insurance and thus reduce, but not avoid, the need to call on a LRS. The additional reforms recommended by the FSCPC would provide far more protection for consumers if they could be implemented.

The changes proposed by FSCPC would also provide incentives to insurers to better price insurance according to risk, thereby aligning their interests more with the ultimate beneficiary of the policies – that is those to whom an insolvent licensee may owe money as the result of professional misconduct. This in turn would provide incentives for firms to demonstrate to their PI insurer, that their internal controls reduce their risk of being found liable for misconduct.

The problem however is that some of these changes have proved to be difficult to implement or may not currently be seen as practicable in the current economic and political climate. **Our conclusion is that the cost of extensive PI insurance reform would outweigh the benefit. PI insurance reform in this area is a blunt and expensive policy tool that in any event will not fully solve the problem. A LRS is a much more cost effective policy response. Overall the costs of introducing a LRS would be spread and shared - under the Report's recommendations the highest costs are concentrated on those consumers who lose their life savings and perhaps their home (if secured against funds borrowed to secure the investment).**

Even an improved PI insurance system would not meet all consumer needs. Where the PI insurer contests claims, the costs of litigation to pursue compensation mean that PI insurance ceases to be an accessible compensation mechanism for consumers. As ASIC Report 240 illustrates, the limited financial and emotional resources of many consumers who have lost their money makes taking action to recover compensation through the courts an inaccessible option. [31]

Moreover, there are some situations where PI insurance cover is not available and the AFS licensee is insolvent, with the result that, in the absence of a LRS, there is no effective mechanism for a person to recover compensation.

The Report acknowledged that PI insurance cover could not cover every situation:

> *"In some cases a policy will no longer be in force or it may not respond to a particular claim or provide sufficient cover. Insolvency issues, policy exclusions, and gaps in the cover that the market will provide, as well as caps on the amount of cover taken out, limit the extent to which professional indemnity insurance can ensure that clients are in fact compensated where they succeed in a claim against a licensee."*[32]

We reiterate our concern expressed in the Joint Consumer Submission to the St John review[33] that: "Consumer representatives urge caution against relying on PI insurance as a stand-alone solution. Even with perfect, standardised insurance policies in place, breaches of the insurance contract by the AFS licensee may still result in the removal of cover for consumers"[34].

5.4 Improved powers for ASIC

The Report recommends that clearer powers be given to ASIC to enforce standards and to sanction firms that do not comply through:

- powers to deal with phoenix activity, both through AFS 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. (Recommendation 2.4)

[31] S. Bell at p 34.
[32] Report at 7.20.
[33] C. Connelly *Review of compensation arrangements for consumers of financial services: Joint Consumer Submission* June 2011 http://futureofadvice.treasury.gov.au/content/consultation/compensation_arrangements_CP/submissions/choice.pdf
[34] *Joint Consumer Submission* June 2011 at 3.1.

The Report recommends that in dealing with AFS 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 license or the amalgamation or takeover of a licensed business (Recommendation 2.5.1).

Consumer representatives support these recommendations. There is evidence that there have been recent instances of phoenix activity.

5.5 A last resort compensation scheme

The Report stopped short of recommending the introduction of a LRS at this stage. The report cautioned against early introduction of a scheme as “a shortcut means of remedying shortcomings in the current regime”.[35]

The Report recognises that its recommended enhancements to the existing system will not, of themselves, ensure compensation for all affected consumers. The Report contemplates introduction of a LRS in due course. Instead, the Report’s expressed concerns about a LRS relate to the timing of its introduction:

> *“7.46 My conclusion is that it would be better to proceed step-by-step and aim to strengthen the current approach as a necessary first stage before consideration is given to any move to a more comprehensive scheme of last resort to deal with compensation claims for licensee misconduct in circumstances where the licensee has become insolvent.*
>
> *……….*
>
> *7.50 The aim should be to reduce the number of cases where consumers cannot recover compensation for losses suffered through licensee misconduct because of the financial failure of the firm in question. To put it another way, the regulatory platform for financial advisers and other licensees needs to be made more robust and stable before a safety net, funded by all licensees, is suspended beneath it.”*

The Report’s logic at this point is difficult to follow. It fully admits that the reforms recommended in the Report will merely work to reduce the number of uncompensated consumers, not avoid the need for a scheme. The quoted text clearly contemplates that a LRS will likely be required in due course. What then are the arguments for delay set out in the Report?

[35] Report at 7.41

The primary arguments are that introduction of a LRS at this time would introduce a "regulatory moral hazard" and that a LRS will do little to improve licensee behaviour.

The Report also expresses concern that a LRS would have better capitalised or more responsible firms paying for misconduct of others, and it identifies problems that it says a LRS will not, of itself, rectify. These include:

- compensation for consumers who suffer loss as a result of investment failure/poor performance
- compensation where products are purchased directly from product issuers
- a so called imbalance of responsibility between advisors compared with product issuers
- compensation where loss is caused by consumers' exposure to outlaws
- product failure through fraud (in absence of breach of obligation by licensee)

The various reasons advanced for a delayed introduction of a LRS are either misconceived or not germane. Each is discussed in turn below.

5.5.1 "Regulatory moral hazard"

The explicit argument, at paragraphs 7.41-7.45, is that to introduce a LRS now would create a kind of 'regulatory moral hazard' in that the incentives for the other changes that the Report recommends would be reduced or undermined. No evidence for this conclusion is cited, and on examination it has little underlying logic.

"Moral hazard" is a term used in economics to describe a situation where there is a tendency to be careless or to take undue risks because the likely cost of doing so is not borne by the party taking the risk. It is commonly used in relation to insurance situations, for example where a person doesn't bother to lock their house, because loss due to theft would be borne by another party, that is the insurer.

The Report's "regulatory moral hazard" argument appears to be based on an assumption that Parliament, the Executive or ASIC would be careless, take undue risks, or perhaps neglect regulatory responsibilities to protect consumers because those consumers may ultimately have recourse to a LRS. There is no reason to believe that introducing a LRS would discourage government or regulator action to improve other aspects of the operation of investment advice including improved PI insurance. It is neither novel nor beyond the power of Parliament and regulatory agencies to introduce several required measures at the one time.

Further, even if a LRS was introduced in advance of other required changes (a course of action recommended by no one) the higher than otherwise necessary contributions expected of industry to the LRS would create a constituency with very good reasons to

advocate for internal reform of poor industry practice and would create opportunities and incentives for ongoing reform where needed.

Responsible businesses would have financial incentives to pressure Government to ensure irresponsible and under-capitalised businesses do not fail and leave liabilities to consumers for compensation where misconduct is found to have caused loss. In other words, the impost on industry required by a LRS would create a constituency for reform and hence place pressure on the Government and ASIC to respond.

5.5.2 Standards of licensee behaviour

A related argument advanced by the Report is that a LRS would not work to improve the standards of licensee behaviour: "Current regulation 'is not tight enough to ... limit the instances in which consumers are unable to recover compensation".

Improving licensee behaviour is not the primary aim of a LRS, which is rather to redress uncompensated loss. Improving standards of licensee behaviour is the role of other measures such as those proposed to improve the operation of PI insurance and, possibly, the Report's suggestions about increasing obligations on product issuers. Licensee behaviour would also be improved by firmer responses to the distorting affect of conflicts of interest, a matter largely ignored by the Report, but addressed to some extent in the FoFA reforms. As discussed in the previous section there is no reason action cannot be taken in both areas at the same time.

However the Report is wrong to think that a LRS will not have positive effects on licensee behaviour. The existence of a LRS is likely to increase incentives for more responsible and better-resourced firms to monitor other licensee's behaviour and alert regulators or the LRS to risks. Moreover, if the scheme is granted powers to assist it to mitigate risk (as we believe it should) then a LRS will have the scope for further positive impacts on licensee behaviour including helping avoid or minimise the impact of collapses of under-capitalised licensees. The LRS could for example be empowered to take action to mitigate its risk by introducing soft "prudential measures", for example by tweaking the capital adequacy requirements in the face of demonstrated problems. The Travel Compensation Fund has powers of this sort. The data and information that could be gathered from a LRS may help inform regulators and assist in future regulation.

Further, it is likely that consumers who would have been dissuaded from asserting their legal rights to compensation under the existing arrangements may be more likely to pursue compensation if they can be confident that, in the event that compensation cannot be paid pursuant to PI insurance and licensee insolvency, they may nevertheless recover compensation under a LRS. More people asserting their legal rights would be likely to create more incentives throughout the sector to improve service and performance.

5.5.3 Stronger and more responsible firms would pay for weaker and less responsible ones

It is correct to say that responsibility for payment of the levy underpinning a LRS would be met by all holders of AFS licences. This is also the case in other last resort compensation schemes, for example the scheme applying to APRA-regulated funds, the Travel Compensation Fund and the schemes that operate in each State and Territory in relation to solicitors' fidelity funds. All such funds, by their very nature require the remaining firms in the industry to pay for losses caused by the misconduct of others. It is therefore difficult to see how this concern is relevant let alone persuasive. Further, it takes insufficient account of the benefits of the existence of a LRS for better-capitalised and more responsible firms, for whom increased confidence in the sector ultimately results in greater client inflows.

5.5.4 Direct investors - consumers who do not seek advice

The Report correctly draws a distinction between consumers who seek advice before investing and those who instead invest directly in a product where the issuer fails. However, the Report appears to treat both classes of consumer as deserving of compensation in an equivalent fashion. Further the Report appears to be written on the basis that a LRS would generally only assist those who invested through an adviser. This is mistaken in two ways.

First, consumers in the two situations are not equally likely to be entitled to compensation. Rather it depends on the relationship and the particular type of misconduct. A consumer should not be compensated for the normal risks of investing. The consumer should be compensated only where the AFS licensee has caused or contributed to the consumer's loss through misconduct, for example, in the case of an adviser, by improperly advising the consumer to invest, or in the case of a product issuer by, for example, making a misleading representation. It is therefore appropriate that the circumstances in which compensation is payable to a person who relies on an adviser are more extensive than would apply to product issuers. The curious equivalence that the Report sees between the position of advisers and product issuers is discussed in further detail at 5.5.6 below.

Second, last resort compensation can and should apply to product issuers who are liable to consumers for causing or contributing to their loss as a result of misconduct.

Product issuers who distribute their product directly to consumers, rather than through a financial adviser licensee, must be members of an EDR scheme (pursuant to the Corporations Law; see RG 165 and RG 139). This enables a person who purchases a product directly from the product issuer to take a complaint to an EDR scheme. Direct investors may be entitled to compensation where the product issuer has engaged in prohibited conduct[1], for example misleading or deceptive conduct, whereas investors

who use advisors may be entitled where the advisor has engaged in different statutory breaches for example inadequate advice. Direct investors therefore may face difficulty demonstrating misconduct because of the more difficult evidentiary burdens in proving prohibited conduct than other statutory breaches (for example inadequate advice). But where licensee conduct is proven, complainants are entitled to compensation and should be covered by a LRS. However if the product issuer is insolvent, consumers will miss out[36]. It is therefore equally appropriate for a LRS to apply to product issuers in this situation as to other licensees.

The Report implies that many losses caused by product failure are the result of a type of fraudulent misconduct that falls outside the scope of the compensation provisions of the Corporations law. Consumer representatives dispute this. However even if it were true, the mere existence of other forms of non-compensable loss does not undermine the case for a LRS for loss that can and should be compensated in accordance with the Corporations Act.

5.5.5 Consumers who invest with outlaws

Consumer groups support Recommendation 2.5.2, which deals with ASIC's role in enforcement in relation to outlaw activity, subject to ASIC's competing enforcement priorities.

5.5.6 Liability as between advisers and product issuers

The Report is particularly focused on a claimed 'imbalance' between the potential liability of advisers and product issuers. The Report gives insufficient weight to the very different role of an issuer and an adviser, and their correspondingly different relationship with consumers.

The Report notes that '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 a purchaser.'

This conclusion is presented in the Report as if this is a problem. But surely those consumers who choose to take and pay for advice should among other things have a greater level of security that they will avoid making poor investments. One objective of getting advice is to help navigate the complex risk/reward relationships on offer.

At paragraph 5.16 the Report claims that it is 'noteworthy' that 'so few complaints about product disclosure or marketing practices have been brought against product issuers'. The Report identifies as a source for this claim Table 3.2 of the Report *which is limited to an analysis of cases involving failed product issuers.* It does not include in this

[36] Unless compensation is available through APRA or SIS schemes which for most SMSF and managed investment schemes investors it won't be.

table data about claims made against product issuers who have not failed. But more importantly, as the Report subsequently acknowledges, in the absence of a LRS there is no point in making a claim against a failed product issuer and so many such claims will not be pursued through EDR or otherwise. It is not possible to use this analysis to conclude that there would not be claims made against issuers if there was any prospect of recovery, and hence the 'imbalance' noted is simply a result of the absence of a LRS that applies to issues and advisers in appropriately complementary ways.

There are a number of better explanations as to why there are few claims against issuers. The industry is structured based on intermediation. Issuers and intermediaries cooperate to make it harder for consumers to invest directly. Issuers use intermediaries, that is financial advisers, as the distribution arm for their products. Many deliberately make it more expensive for consumers to purchase directly to support their distribution system. Advisers support this arrangement and benefit from it. And of course it is the adviser who knows the circumstances of the consumer and provides advice on that basis. The issuer is not privy to that information and thus in a completely different position to the adviser.

The Report then notes (5.19ff) that in cases where the product issuer has failed a consumer who has suffered loss will look at whether or not their adviser has contributed to their loss. It correctly points out that the adviser has an obligation to provide personal advice, and where they have failed to discharge that obligation in accordance with the law, they may be liable to the consumer. The Report contrasts the more limited obligations on the product issuer, including the obligation not to mislead.

Again the Report seems to think this is a problem. In fact it is the considered design of the regulatory system to place a higher onus on AFS licensees offering personal advice. In trying to equate the level of responsibility of advisers and product issuers for potential harm to a consumer who seeks financial advice, the Report appears to be inconsistent with current policy objectives.

The Report suggests that advisers can sometimes be the subject of claims of misconduct where the cause of the consumer's loss lies with the product issuer in whole or in part. The Report observes that it is only natural that a dissatisfied complainant will look to a solvent or insured adviser to pursue a claim in preference to an insolvent product issuer.

There is, further, a largely unstated implication that EDR schemes are somehow bending the rules by awarding to consumers compensation for losses from advice that 'really' flow from the fraud or misrepresentation of the product issuer. No evidence is provided that this may be happening. By implying – incorrectly – that there is some equivalence in responsibility between and adviser and an issuer the Report makes this look like a problem that needs to be fixed. The truth of the matter is that consumers are entitled to expect that they will be in a better position if they take advice than if not. Why else

would they pay for personal financial advice? The adviser is aware of the consumer's personal situation and risk appetite and ought to act accordingly. The adviser has a much higher level of skill and access to information with which to assess products and product issuers. It is that expertise that the consumer is paying for. The proportionate liability concerns raised by the Report are a red herring.

> **Case Study 8: EDR approach to causation**
>
> Something more than a breach of s945A must be shown at EDR. The breach must have also caused the consumer's loss. This means the question of shared responsibility doesn't really apply.
>
> In Westpoint (a case of a risky product paying very high commissions to advisers), all advisers wanted FOS to bring in all other responsible parties (including Westpoint's auditors and Directors).
>
> FOS' Special Panel focused on whether the adviser had suitably advised the investor to invest in a high-risk product.
>
> This is because investors rely on a skilled adviser, just like other professionals such as a lawyer or doctor. Whether the product provided is shonky was not a relevant consideration to FOS' determination[37].

In being concerned about misallocation of responsibility between advisors and issuers, the Report appears to have underestimated the extent to which advisers put people into these products in order to earn high commissions rather than giving the advice they are meant to give for example that this is a very risky product or one to avoid altogether.

Trio is an excellent example. The PJC found that many investors put money into Trio managed investment schemes and super funds based on the advice of financial advisers.

It discovered clear 'regional clusters' of victims of Trio based on the locality of operations of particular financial advisers, including Tarrants in Wollongong, Seagrims in regional South Australia and Mr Paul Gresham on Sydney's North Shore. It found that the evidence suggests that their recommendations to invest in Trio were influenced by the high commissions paid.

The PJC also commented on the importance of the role played by financial advisors given the lack of prudential regulation of SMSFs:

> *The lack of stringent prudential regulation of SMSFs means that the role of finance professionals is extremely important in both the decision to set up an SMSF, in developing its investment strategy, in implementing that strategy and in*

[37] Stephen Duffield, personal communication June 2012.

> *complying with taxation laws and managing risk. Accountants' advice about the taxation implications and appropriateness of particular superannuation structures, such as SMSFs, and financial planners' advice about the investment strategies and risks of such funds will generally be central to people's decisions about the structure of their superannuation affairs. While a SMSF investor and trustee will frequently use other finance professionals, such as auditors and actuaries, in their superannuation dealings, accountants and financial planners are generally people's entry point into the SMSF sector and, as such, occupy a key role in the sector.*

The Report has largely accepted submissions from financial advisors that they bear disproportionate responsibility compared to product issuers [7.33]. However, it is the difference in the performance of different financial products, and the risks associated with them including the possibility of them failing, that is the reason people pay for advice from advisors. A key role of financial advisers is to assess the risks of different investment options.

In fact there is a high prevalence of poor advice from financial advisers, and conflicts of interest arising from adviser remuneration (including commissions) that has played a key role in riskier products being recommended as demonstrated by the latest in a series of research reports by ASIC (see box 1 below).

Of course, the ASIC shadow shop was conducted under current regulatory arrangements, which are about to change with the recent introduction of the FoFA reforms[38]. Much of the poor advice stems from a conflict of interest between the remuneration of the adviser and the interests of the consumer. The FoFA reforms will eliminate some of those conflicts but asset based fees and commission-like arrangements with ongoing fees will see many conflicts continue and thus some incentives for inadequate advice will remain. The PJC also noted[39] the imminent reform of the financial advice sector through the implementation of the FOFA legislation and that some of the financial advice given to Trio clients may have been in contravention of the 'best interests' test and conflicted remuneration provisions which commence from 1 July 2013.

Box 1: ASIC Research on Retirement Advice

The findings of ASIC Report 279 *Shadow shopping study of retirement advice*, published in March 2012, illustrates how widespread the problem of poor financial advice is. Of the personal advice provided, 39% failed to meet the requirements of s945A (requirement to have a reasonable basis for the advice). Only 3% were considered good quality advice, while 58% were adequate.[40]

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[38] Corporations Amendment (Future of Financial Advice) Act 2012; assented to 27 June 2012.

[39] *Inquiry into the collapse of Trio Capital*, xxii.

[40] ASIC Report 279 *Shadow shopping study of retirement advice* March 2012 at para 18ff.

Interestingly, 86% of participants felt they had received good quality advice and 81% said they trusted the advice they received from their adviser a lot. In many instances where participants had received poor or adequate advice, they still reported feeling satisfied with their adviser and the advice experience.

Supply-side problems include product-focused advice and conflicts of interest that limit the quality of the advice being provided, a heavy reliance on pro forma advice, and the need to improve training and professional development. On the consumer side, the main problem resides in the difficulty consumers have in evaluating the quality of advice they receive.

In most cases (64%), the financial products recommended were appropriate and in line with the client‘s personal circumstances. In 16 advice examples, the financial products recommended did not suit the client‘s personal circumstances, having regard to the strategy recommended and the risk tolerance. In 16 of the advice examples, the investigation of the client‘s personal circumstances was poor. In 15 of these 16 examples (94%), the overall quality of advice was also rated as poor.

In 78% of the advice examples, the adviser was remunerated through product commissions or fees that were based on a percentage of the client‘s assets or investments under advice. While the method of remuneration was not considered when the quality of advice was being evaluated, none of these advice examples were rated as good. Where advice fees were contingent on a product recommendation, there were numerous examples where the advice appeared to be structured towards recommending or selling financial products. In some cases, this was at the expense of optimal strategic advice, and prevented some otherwise adequate advice from being rated as good.

Some clients were given pro forma advice not tailored to their particular circumstances.

Approximately two-thirds of the total sample contained recommendations to replace one financial product with another. There were cases where clients‘ superannuation was switched into inappropriate or more expensive products, often in-house products, without obvious advantages to the client. There were also shortcomings in the information and warnings provided by advisers.

The scope of most of the advice reviewed was limited in some way. In several instances, particular topics were excluded from the scope of the advice, to the potential benefit or convenience of the adviser, and to the significant detriment of the client.

5.5.7 Product failure through fraud

The Report points out that there may be cases of fraud by product issuers where an investor who has suffered loss cannot point to a breach of the Corporations law. The Report notes:

> *The ability of consumers to claim compensation would still depend on being able to show they had suffered loss as a result of the breach by a licensee of a relevant obligation, such as the bar in section 1041G on dishonest conduct. (Paragraph 3.46)*

This statement is correct. However the Report offers no evidence as to the prevalence of cases where consumers cannot show a breach of the Corporations Law. In any event the existence of otherwise of such cases is not relevant to whether or not a LRS should be introduced. Where a licensee has breached the Corporations law and that breach has caused loss to a consumer, they should be compensated. If a person who happens to be a licensee has committed fraud on a person other than as a licensee outside the scope of the regulation of financial services then that is a matter for the general law and should not be addressed through a compensation scheme which will be ultimately funded by consumers of (licensed) financial service providers.

Unfortunately the Report proceeds from paragraph 3.48 on the mistaken basis that this is a relevant consideration.

5.6 Recommendations to improve conduct by product issuers

Our conclusion that there are material differences between the situations of consumer who have suffered loss as a result of the misconduct of product issuers and licensees does not, however, mean that there may not be scope for improvements in the obligations placed on product issuers.

The Report recommends that certain approaches drawing on overseas proposals should be given further consideration. The Report notes that 'the review has not had an opportunity to test' these proposals, but puts forward for consideration

a. more positive obligations on product issuers in regard to the suitability of their products
b. standardised product labelling (around terms such as 'capital guaranteed' for example)
c. "keeping in mind" the role of research houses

(Recommendation 3.1).

These are all meritorious, if not particularly detailed, proposals that are worth further exploration. In relation to the possible benefits of product issuers (in particular managed investment schemes) being subject to a suitability requirement, the Report notes very

rough parallels with the requirements in relation to consumer credit[41] and some initial overseas interest in exploring such an approach to regulation.

Consumer representatives support further policy development in this area, especially if it puts the onus on product issuers to assess whether an overly complex product is suitable for each retail investor on a case-by-case basis. However as far as we are aware, there are no concrete proposals currently under consideration in Australia for any of these reforms. In any event, such reforms would be unlikely to have a significant impact on very many of the uncompensated losses incurred by consumers. This is partly as most rely on the sorts of disclosure approaches which are unlikely to steer very many consumers away from unsuitable investments in the face of clear advice from a trusted financial adviser that the investment is in their interests.

5.7 The Introduction of a last resort compensation scheme should not be delayed

As noted at 4.4 above, there have been at least $2.4 million in unpaid FOS awards and $63 million in total claims against insolvent members for the period of 2.5 years since the period used for the FOS data quoted in the Report . Further, both the proportion and total amount of consumers' retirement savings that are placed in SMSFs is expanding rapidly (see 4.4 above). Retirement savings invested through SMSFs do not benefit from the potential for compensation through the SIS Act in the event of uncompensated loss. Given the devastating personal, social and economic impacts, a LRS should be introduced as soon as possible**. Consumer groups do not support the conclusion that a LRS should be considered only at a future time. If, however, government was minded to first introduce the specific actionable recommendations of the Report, then it should also set a deadline for the introduction of a LRS. The most effective way to do this would be to enact the legislation required to underpin a LRS at the same time as introducing the changes to capital adequacy requirements, PI insurance and regulator powers recommended in the Report. The legislation would specify a start date for the LRS two or three years after the legislation is passed.**

5.8 Operation of scheme

The Report considers the possible design and governance of a LRS, should one be introduced.

Unfortunately the proposal put forward is administratively complex and requires a great deal of double handling which will add to the cost of the LRS. The result will be that a

[41] In fact there is no real parallel with the consumer credit requirements as managed investment product issuers cannot know the full circumstances of direct invested clients in order to make a suitability assessment.

considerable proportion of the funds levied on industry and ultimately paid by consumers will be wasted on the administration of the scheme.

Consumer representatives support the Report's recommendation that a new body be created. However consumer representatives do not support many of the specific suggestions around the operation of the scheme. These are discussed below.

5.8.1 Different liability standard

There is no case for a different liability standard. The report at 2.180 notes 'concerns' with the liability standard used by EDR – including that a LRS should not respond to awards based on good industry practice. These concerns are unfounded and have not been discussed with consumer representatives and possibly also other stakeholders. This feature does not resonate with the conclusions of the many multi-party reviews of ASIC-approved EDR schemes that have been conducted over the past dozen years.

5.8.2 Eligible claims

The LRS should be limited to retail clients (the Report makes no finding either way). That being said, there is no need to limit the maximum claim – rather the maximum compensation available should be limited.

5.8.3 Acceptance of EDR findings

The Report does not propose that Court or EDR findings should be the basis for a claim on a LRS, in part perhaps due to (unjustified) discomfort with the liability standard. This conclusion requires matters to be re-litigated which would be a terrible waste of resources for no useful policy outcome.

Research commissioned by ASIC in 2009 also found that complainants who had their complaint addressed in a more timely manner were more satisfied with the complaints handling process. Arguably long delays at the LRS end could also contribute to dissatisfaction with the overall complaints handling process.

5.8.4 Amount of compensation

The Report suggests that the compensation payable under a scheme should be capped and tiered. Consumer representatives support this approach however we note that the Report proposes caps and levels of compensation which seem unjustifiably low. We note that the SIS Act provides for compensation of 90c in the dollar.

5.8.5 Should Government contribute to the costs of a last resort compensation scheme?

While the primary reason for establishing a LRS is to ensure that consumers who suffer loss as a result of licensee misconduct are compensated, a LRS is also effectively an important part of the regulation of the industry. Government (and through it the community) benefits as the regulatory framework will be more effective. Government and taxpayers will also benefit in reduced calls on social security, health and other welfare services. There may therefore be a case for Government to make a small contribution to the start up and/or operating costs of the LRS.

5.9 Cost benefit assessment in relation to a last resort compensation scheme

Consumer groups believe that the benefits of introducing a LRS would outweigh the costs of *not* doing so. Such a reform package would also create incentives to reduce costs and would share losses more equitably. The cost benefit case for reforms including a LRS is superior to alternatives including the more limited set of reforms recommended for immediate action by the Report, more extensive reform of PI insurance as advocated by the Financial Services Consumer Policy Centre in 2002 or doing nothing.

The costs of doing nothing are well known and include the individual financial, emotional and social costs (outlined in section 4.1 above), the impact on communities where a significant cluster of consumers suffers uncompensated loss (5.5.6), the costs to Government and the community in increased health and welfare services (4.2) and the reduction in confidence in the financial services industry, regulators and EDR schemes (4.3).

Implementing the approach recommended in the Report will mean the same range of costs as are currently incurred will continue. The benefit of the Report's approach will be some reduction in the incidence of the problem. There will likely be some additional costs incurred through higher insurance premiums. There may also be a reduction in the number of firms in the industry and a possible (although probably marginal) reduction in access to low cost advice.

Establishing an efficient LRS together with the reforms to capital adequacy, PI insurance and regulator powers recommended by the Report would largely eliminate the incurred costs currently arising from uncompensated loss due to licensee misconduct.

Counterweighing against the costs of a levy, which would ultimately be borne by consumers, are significant benefits to consumers (reassurance, payment of last resort claims) and the financial services industry (increased consumer confidence) both of which are recognised by the Report (7.9). In addition we suggest there would be substantial social benefits including reduced calls on public funding for social and health services, and that in addition to increased confidence in the financial service industry there would also be important gains in confidence in regulation, regulators and EDR schemes.

Providing certainty that obtaining an award of compensation will actually result in compensation being paid will restore integrity and confidence in EDR schemes, encourage and give confidence to consumers to pursue their right to claim under such schemes. There will also be a flow on effect for industry, the regulator and Government in terms of confidence and trust.

The costs of achieving these considerable benefits, above and beyond the modest benefits likely to arise from the Report's recommendations, comprise the cost of operating the LRS and the cost of funding the payouts to consumers. An efficiently run scheme doing the minimum work required to be done to solve the policy problem, together with a tiered and capped approach to compensation (see 5.8) will keep these costs to the minimum necessary. The costs of the LRS would largely or entirely be met by an industry levy ultimately shared among all consumers of the relevant financial services, as is the case in relation to other schemes of last resort in the financial services industry and elsewhere.

As noted at 5.8, the Report proposes an unnecessarily expensive model for the operation of the scheme as it unnecessarily requires all claims to be reassessed.

A LRS is the most efficient and effective policy response both in monetary terms, and in terms of the greatest net benefit to society.

The Report acknowledges that having regard to the cost benefit equation is important. The Report suggests that "the challenge is to strike a balance between the effectiveness of any enhanced compensation arrangements in protecting retail participants and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services of retail clients and the overall efficiency of the sector."

Unfortunately the set of reforms advocated in the Report will impose some clear costs but will not solve the problem or reduce it to an acceptable level.

5.9.1 Financial costs associated with the proposed levy and the proposed changes to PI insurance

The Report did not explicitly attempt to calculate the costs of a LRS on industry, nor the possible financial impact of those costs on consumers as they are passed on in higher charges (or lower returns) for products and/or advice.

The Report did express concern:

- that a LRS would have the effect of imposing on better capitalised and/or more responsibly managed licensees the cost of bailing out the obligations of failed licensees [7.43]
- about the possible rising cost of or reduced access to PI insurance.

Levy imposed on solvent firms It is clear that there will be costs imposed on non-insolvent firms in the sector. While the Report found it difficult to quantify those costs, the Report concluded that "*the incidence of claims where consumers cannot recover compensation to which they are entitled is substantial but not all that large in overall terms*" (7.28) noting that evidence from ASIC and FOS that there are a number of small and medium sized licensees that are wound up each year with outstanding compensation liabilities running to several million dollars. Experience in the UK, where a LRS is currently in operation, offers further comfort that the costs of a LRS will be manageable and will not significantly increase the cost of financial products nor reduce the supply of worthwhile products.

The fact that costs are imposed on firms not guilty of misconduct and/or not insolvent is not material for the reasons discussed at 5.5.3 above.

Cost of reforms to PI insurance Although the Report expressed concern about the possible rising costs of or reduced access to PI insurance, consumer representatives are not sure that the costs of proposed reforms to PI insurance may have been fully identified. Whichever view is correct, the costs will be largely the same under the Report's proposals on one hand and the type of LRS advocated for by consumer groups on the other. Over time, the additional discipline imposed on the industry by a LRS (see 5.5.1) may in fact reduce losses faced by PI insurers and allow premiums to fall.

5.9.2 Last resort compensation scheme design to keep costs down

At 5.8 above we criticised proposals in the Report that would have the effect of increasing the operational costs of a LRS. **The LRS should be designed to do the minimum necessary to ensure EDR scheme and court awards are paid and include other reasonable measures to keep the total cost of operation low. In particular:**

- **allow larger claims to be capped;**
- **require only a small annual levy;**
- **rely on post-event levies for major incidents;**
- **return excess funds to members.**

5.10 Recommended changes to EDR

The Report recommends that ASIC should give more attention to the adequacy of EDR scheme processes (Recommendation 2.5.5). **Consumer groups believe that this recommendation is unjustified and unnecessary and that the St John Review did not do enough to inform itself about the issues at stake in relation to the efficient, effective and fair operation of EDR schemes.**

The remarks about EDR schemes (pages 46-47 of the Report) pick up on concerns raised from time to time by a minority of industry participants. **These concerns were not discussed or tested with consumer representatives in the course of the review (they were not raised in the Discussion Paper) and are based on a limited perspective of the EDR schemes.**

A number of the features of EDR schemes noted as 'concerns' are essential to their efficient and effective operation. These include the liability standard, that the EDR schemes do not charge consumers, that there is no right of external review.

There is no case for a charge on consumers to access EDR schemes. Accessibility, independence, fairness, efficiency and effectiveness have been long standing principles supporting EDR schemes in the Corporations Law. ASIC's approval and continuing oversight requirements flow from these principles. To adopt these suggestions would undermine these principles. EDR schemes do not impose a charge on consumers to access their services. The cost of a licensee's complaints handling system is shared by all customers of the licensee and built into the cost of their products or services. The absence of cost removes yet another reason why a consumer may not pursue a complaint in an already difficult to navigate system. ASIC Report 240 identifies a number of barriers to taking up complaints already faced by consumers. It showed that many consumers were not willing to risk losing more money and were ashamed or embarrassed to complain even if they had a reasonable basis for making a complaint. In any event applications to the scheme do in fact result in costs to consumers in terms of time and obtaining of advice, providing documents, etc (see Case Study 3 at 4.3 above.)

The absence of a right of review and the extension of the liability standard to good industry practice have been features of EDR schemes in Australia and around the world for many years. They will of course be criticised from time to time by parties who get results that do not suit them, however they are largely accepted as striking the right balance between fairness and accessibility. A right of review at EDR, for example, would enable the better-resourced party – invariably the AFS licensee – to drag out proceedings and offer further barriers to a consumer pursuing their complaint. It may also create an environment where complainants simply give up because it becomes too hard. In serious cases it would exacerbate the harm caused to the consumer by the loss.

As part of ASIC's requirements in RG 139, the operations of the EDR schemes are subject to independent review within the first three years of approval and thereafter once every five years. They have been reviewed numerous times without any finding that these matters undermine their efficiency, effectiveness or fairness[42]. It is of course appropriate that all matters of operation of the EDR schemes are reviewed from time to time by the schemes themselves, and by ASIC (where relevant). The raising of

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42 While FOS has not yet been reviewed since it was established, its predecessor schemes were reviewed several times before being merged into FOS.

‘concerns’ in the Report without full review of past discussions and without raising the issues with stakeholders is unfortunate.

The Report’s concerns about EDR are not justified. This issue is outside the scope of the review as it is not relevant to the question of whether or not a compensation scheme is required. The kind of changes that the Report has in mind would in some cases undermine the integrity and effectiveness of the scheme. We understand these concerns are not widely supported across the financial services industry. They are strongly opposed by the EDR schemes and all consumer groups. Moreover, whatever the merits of those reforms, they will do nothing to assist in the resolution of the problem of consumers who are not compensated for losses where a licensee, who has found to have caused loss through misconduct is unable to meet an award from their own resources or through their PI insurance.

5.11 Apportionment of responsibility for loss between product issuers and advisers

Recommendation 3.2 of the Report suggests “some rebalancing of responsibilities of product issuers and financial advisers towards retail clients could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct among ... licensees”.

Consumer representatives do not support this recommendation as it based on a complete misconception of the relationship between financial advisers, product issuers and consumers.

Moreover this fails to recognise that Division 2A of Part 7.10 of the Corporations Act, which provides for apportionment, is of extremely limited application. First, it only applies to liability for one type of prohibited conduct, namely misleading and deceptive conduct, and does not apply either to the other types of prohibited conduct in Division 2 of Part 7.10, or to the other compensable grounds commonly dealt with by EDR schemes, such as those under s 912B. Second, it only applies to compensation for indirect loss, whereas the main EDR scheme, FOS, generally has jurisdiction only over direct loss[43].

There is authority[44] for the proposition that proportionate liability has no place in EDR schemes, which work on the basis of membership and are set up to make awards of compensation:

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[43] Financial Ombudsman Service *Terms of Reference* 1 January 2010 (as amended 1 January 2012) http://www.fos.org.au/centric/home_page/about_us/terms_of_reference_b.jsp at 18 Remedies. FOS caps the amount of indirect loss it can award at $3,000 per claim in addition to the $280,000 cap it can award for direct loss. COSL's $280,000 cap includes both direct and indirect loss.

[44] *Financial Industry Complaints Service (FICS) Ltd v Deakin Financial Services Pty Ltd* [2006] FCA 1805.

- for a range of breaches of statutory obligations, including inadequate advice, and
- via a mechanism that is cooperative, efficient, timely, fair and with the minimum formality and technicality[45].

Moreover, the part of the recommendation that would require EDR schemes to join further parties to EDR processes, namely the product issuers, is likely to result in the EDR process becoming more court like, slower, more complicated, and less accessible to consumers.

Consumer representatives believe that the current approach of the EDR system to cases where there is a product issuer and an adviser involved is the correct approach. A consumer may make an EDR complaint against whichever licensee caused them harm.

The problems are that advisers and issuers may become insolvent, advisers PI insurance may be inadequate and in either case the consumer may not recover their award. The solution is to introduce a LRS. If so, consumers would more confidently take action against the party that has caused harm. Likely the number of matters taken against (insolvent) product issuers would increase. However given the trust placed in advisers one would expect that the number of advisers subject to complaint in matters where advisers and issuers are involved would remain higher.

6 Conclusion

The primary measures that Government should take to protect consumers from the consequences of losses that flow from the misconduct of AFS licensees are measures to:

- **improve capital adequacy requirements on AFS licensees**
- **improve PI insurance requirements that apply to AFS licensees**
- **introduce a LRS that would apply in cases where a person is unable to recover their loss through PI insurance.**

Of these measures, it is only the creation of a LRS that will ensure that consumers entitled to compensation for licensee misconduct are not unfairly denied payment. Moreover, creation of a LRS is a more cost effective policy response than relying only on the proposed reforms including those to capital adequacy and PI insurance. The latter can only be taken so far without incurring unwarranted cost and/or running into barriers inherent in the PI insurance industry.

[45] Financial Ombudsman Service: *Terms of Reference*.

This conclusion is at odds with the primary recommendation of the Report, that it would be premature to introduce a LRS until other reforms to the 'lightly regulated' managed investment schemes sector are put in place. The submission demonstrates that the Report's primary reasons for coming to this conclusion are misguided.

Consumer representatives strongly support the introduction of a LRS at this time for the reasons provided in this submission, in conjunction with a range of other reforms to strengthen the existing regulatory system.

Consumer representatives would welcome the opportunity to discuss this submission further.