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Our Ref:

3 June 2011

Mr Richard St. John
Statutory Compensation Review
PO Box 6295
Kingston ACT 2604

By Email: futureofadvice@treasury.gov.au

Dear Mr St. John

Review of Compensation Arrangements for Consumers of Financial Services
Submissions of Slater & Gordon

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1. We refer to your April 2011 consultation paper, which addresses issues relating to compensation arrangements for consumers of financial services (the **Consultation Paper**).

2. You have sought feedback and comment from interested parties on the issues outlined in the Consultation Paper. Slater & Gordon has acted for thousands of investors in individual and representative proceedings to recover compensation for financial loss suffered following some of Australia's biggest financial services collapses, including Westpoint, Storm Financial, Opes Prime, Basis Capital and Fincorp. We have also, for the last decade, regularly acted for individuals who have suffered financial loss as a result of negligent or inappropriate financial advice in legal claims against the financial service provider in question.

3. In our experience, the legal causes of action and forums for redress available to consumers of financial services are satisfactory, and do not require reform. However, it is also the case that these rights may be enhanced through certain of the current reforms being considered by the Future of Financial Advice (**FOFA**) reviews, in particular those that may potentially relax the current financial distinction between retail and wholesale investors.

4. In our opinion, the FOFA reviews have correctly identified the central issue requiring reform; namely the difficulties and/or inability of consumers with legitimate claims to recover their loss where the Australian Financial Services License holder (the **licensee**) that gave them inappropriate advice is insolvent, and/or has no or insufficient insurance.

5. In our submission, the reforms arising from this review should focus on:

   a. improving the coverage and transparency of professional indemnity insurance arrangements; and

   b. introducing a second-tier fund of last resort (similar to that operating in the UK) that will allow consumers to be compensated in the event that their claims are not met by insurance.

6. The purpose of this submission is to outline in more detail the systemic inadequacies that limit a consumer's ability to recover compensation, and how these inadequacies might be addressed.

Inadequacies in current compensation arrangements

7. In our experience, the three central factors that limit a consumer's ability to recover compensation are as follows:

    a. licensees holding inadequate professional indemnity insurance (e.g. cover that is insufficient in amount, or a policy that excludes financial products recommended by the licensee);

    b. consumers being unable to access basic information concerning whether a licensee has sufficient professional indemnity insurance to meet their claim; and

    c. the inadequacy of existing regulations in relation to the amount and scope of the insurance that licensees must maintain.

<u>Limitations of professional indemnity insurance held by licensees</u>

8. In our opinion, the current professional indemnity insurance arrangements are only partially effective. All too often, consumers with strong claims against financial service providers, either:

    a. are unable to recoup their losses due to inadequate insurance being maintained; or

    b. do not proceed with litigation due to the uncertainty about whether there will be sufficient funds available at the end of the proceeding to satisfy their claim.

9. As acknowledged by the Insurance Council of Australia:

    > PI insurance is a commercial product, which in this case is designed to protect the financial well being of the insured financial advisor or AFS Licensee. It is not designed to enable compensation to be paid to third parties, although in many cases the money received under the policy is on-paid to third parties enabling a wronged client to be compensated.[1]

10. In our experience, consumers face the following barriers when seeking to recover compensation from insured financial service providers. These include:

    a. monetary limits of insurance policies being inadequate to cover the magnitude and/or multitude of claims;

    b. exclusion clauses in insurance policies limiting the application of the policy, such that many activities carried out by the financial service provider are effectively uninsured;

    c. the effect of aggregation clauses; and

    d. the inclusion of defence costs within policy indemnity limits, rather than as a separate item.

11. These issues are amplified in the context of large groups of similar claims against a single financial service provider. In assessing the ability of professional indemnity insurance to adequately compensate consumers, and the possibility of reform, proper consideration must be given to these sorts of claims.

12. At a basic level, the total amount of compensation sought by groups of claimants is more likely to exceed a policy's limit of indemnity, leading to inadequate compensation for each individual. Even the current maximum coverage of $20 million recommended in ASIC's Regulatory Guide 126 to licensees (**RG 126**) spreads thinly through a group of hundreds of

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[1] Insurance Council of Australia submission to the Parliamentary Joint Committee On Corporations And Financial Services dated 6 July 2009.

claimants with losses typically seen in inappropriate advice claims. In the case of the collapses referred to about, the number of potential claims was in the thousands. Those insured need to be more realistic about the prospect of high value group claims when assessing the adequacy of their insurance arrangements.

13. The circumstances leading to a potential claim against a financial service provider often do not occur in isolation. In our experience, financial advisors seek to commoditise their provision of advice by:

    a. adopting standard descriptions of financial products for inclusion in statements of advice;

    b. categorising financial products by risk category or investment class when constructing an approved product list (**APL**);

    c. holding seminars for groups of clients, and widely-distributing standard promotional material concerning a financial product or service.

14. Each of these business practices means that, if the standard form material is incorrect or contains a material misrepresentation, then there is a good prospect that a significant number of a licensee's clients (particularly those meeting a particular risk profile) will have a similar if not identical claim against the licensee. For this reason, "group claims" based on such misconduct are increasingly becoming a feature of the litigation landscape.

15. In light of the above, it is imperative that compensation arrangements anticipate and adequately provide for the very real possibility that a claim for compensation against a financial advisor will not be isolated or one-off, but rather one of many claims that would each be brought at or about the same time.

16. We note that ASIC RG 126 at its highest *suggests* that licensees should consider the potential for multiple claims in determining the adequacy of professional indemnity insurance. We submit more direct guidance and regulatory scrutiny ought to be considered.

17. Depending on the wording of the policy, aggregation clauses can lead to unjust results for group claims. Whereas an individual's total losses may fall under the limit of indemnity, a group member will likely have to share with many others in the monies available under the aggregate limit of indemnity. This effectively punishes the consumer for the systemic misconduct of the financial service provider.

18. The results are particularly harsh given that the limit of indemnity under a policy typically includes the costs associated with defending any legal claim. This can lead to an outcome where the monies available to pay claims under the policy are substantially depleted through defence costs by the time an action is ready to be resolved. Even where a defence is unmeritorious, the plaintiffs have little to no recourse against the insurer for the depletion of the funds available under the policy. Further consideration should be given to the legislative amendments to enable third party consumers to seek remedies against insurers in such situations.

19. The incorporation of wide exclusion clauses into insurance policies often renders insurance policies ineffective. In particular, policies will often confine an insurer's obligation to indemnify the licensee to advice that was provided in accordance with the terms of the AFSL and/or in relation to products that appear on the licensee's APL.

20. In a manifestly unfair information asymmetry, at no stage in the process do consumers have any right to access the insurance policy, or the licensee's APL. Accordingly, they are not able to select a financial advisor with any reference to the security that would otherwise be provided by information concerning the effectiveness of compensation arrangements in the event that the advice did not meet the requisite standard.

21. In many cases, the first and only indication that a licensee is insured is given by the identity of the solicitor who appears on the record for the defendant following the commencement of proceedings.

22. In the event that indemnity is denied under an insurance policy, consumers are left to speculate on the basis for that denial. As they are not a party to the insurance contract, they are unable to challenge that denial in any event.

23. Ultimately, the current insurance arrangements cannot be readily disentangled from their genesis as commercial arrangement between, and for the benefit of, the insurer and financial service provider, rather than a direct means of compensation for the consumer.

Case Study – Storm Financial

a. The collapse of Storm Financial provides a compelling example of the way in which limited insurance policies can negatively affect consumers' rights to recovery.

b. Professional indemnity policies are triggered by claims made by the insured and notified to the insurer during the policy period. In relation to Storm:

   i. most clients of Storm became aware of losses they had suffered during or after December 2008; and

   ii. accordingly, their claims prima facie will within the scope of a policy issued by Chartis Insurance (formerly known as AIG) that provided cover in relation to claims made and notified between 10 December 2008 to 10 December 2009 (the **2009 policy**).

c. Chartis informed Storm clients that it was likely to deny indemnity under the 2009 policy in relation to any claims they might make on the basis that Storm had not complied with its obligations of disclosure, when obtaining the policy from AIG. In particular, the following facts were said to have been withheld which, if disclosed, would have meant that the policy would never have been written:

   i. very significant problems were emerging in relation to Storm's margin loan clients;

   ii. the directors of Storm considered that its clients may have legal rights against Storm for this reason; and

   iii. Storm was insolvent from 1 December 2008.

d. Some Storm clients have claims against Storm relating to conduct that occurred within the period of cover under a *previous* insurance policy. In this regard, the insurer's position is that it is entitled to deny indemnity due to Storm's failure to notify AIG of the fact and circumstances giving rise to such claims within the policy period.

e. As discussed at paragraph 2.21 of the Consultation Paper, ASIC declined to include a requirement in RG 126 that financial planners hold "run-off cover", on the basis that insurers generally were not willing to provide this risk feature for licensees.

f. Slater & Gordon is aware of many instances where Storm clients have successfully obtained determinations against Storm through the Financial Ombudsman Service (**FOS**), but have been unable to enforce the award. At best, they rank as unsecured creditors in the liquidation of Storm, and are unlikely to receive a distribution of proceeds.

g. In our opinion, the above demonstrates the risks for retail clients resulting from:

i. the requirement that claims are "made and notified" within a policy period, in the absence of any requirement that licensees hold run-off cover; and

ii. the inadequacy of the RG126 requirement that insurance policies include coverage for liability arising out of the fraud or dishonesty of the licensee or its officers, in circumstances where the 12 month policy period allows the relevant insurer to deny liability on the grounds that the licensee had failed to comply with its obligation of full disclosure about the fact of their fraud when the policy was renewed.

h. We further note that investors are generally not aware that they are required to "make a claim" against their licensee within the (unknown) policy period in order for their claim to attract indemnity. In the case of Storm, Slater & Gordon submitted notices of claim on behalf of thousands of clients to Storm's liquidators, in order to protect any rights in the event that coverage was available. However, there are many instances where potential claimants will not have sought legal advice prior to the expiry of the relevant insurance policy, and so find that their claim will not be covered.

24. A last resort compensation fund, correctly framed, would provide a fall back position for retail clients in circumstances where either or both of the above grounds for the unavailability of indemnity are cited by insurers.

25. In addition to the above, we have occasionally been approached by investors who received financial advice from an advisor who was not licensed, whether at all or in respect of the financial service that caused the loss complained of.

26. In such cases, the main barrier to an investor obtaining compensation is that the advisor is uninsured or that a relevant exclusion clause in the insurance policy applies.

27. An example of the later occurred in relation to Westpoint. On-line Super Pty Ltd (**On-line Super**) provided recommendations to hundreds of its clients to invest in Westpoint. However, it did not have a license, nor did it have insurance. On-line Super's clients were left in a position where they effectively had no recourse for their losses.

28. Where the financial advisor is unlicensed, individuals cannot bring a claim through FOS because, by definition, the unlicensed advisor will not be a member.

29. In our opinion, a retail client is entitled to assume that a financial advisor operating in a regulated market is appropriately licensed, and that the financial services offered fall within the scope of that license. Where this is not the case, a fund of last resort would prevent the burden of this wrongdoing being shifted to the client.

Access to Information about Insurance

30. Currently, consumers have limited means of obtaining information about insurance in order to evaluate the prospects of recovery. In many cases, it is not until plaintiffs have reached an advanced stage of litigation and significant costs have been incurred that it is discovered that an insurer has denied cover under the relevant policy or that the limits of indemnity mean that the action is, or always was, economically unviable. The variability of insurance policy terms makes it difficult for consumers and/or their lawyers to assess and predict the likelihood of recovering their losses through insurance policies.

31. Plaintiffs or potential plaintiffs ought to be entitled to obtain, at an early stage, basic information regarding insurance policies held by their financial service provider including the limits of indemnity, the terms and conditions of the policy, whether or not defence costs are included in the limit of indemnity, the identity of the insurer and the basis for any exclusion of liability.

32. A standardised set of approved policies, which have been designed with close attention to the potential issues raised above, may do much to improve this situation for consumers.

33. Furthermore, we believe ASIC should provide more guidance to licensees regarding the adequacy of their professional indemnity insurance and undertake regular and systematic reviews of the adequacy of insurance held by licensees.

34. ASIC's RG 126 stipulates that a licensee should determine the minimum adequate level of professional indemnity insurance coverage by reference to, among other things, "*the maximum liability that has, realistically, some potential to arise…in connection with any particular claim against you and all claims for which you could be found liable*," having regard to:

    a. the maximum exposure to a single client;

    b. the number of claims that could arise from a single event; and

    c. the number of claims that might be expected during the policy period.

35. We consider that RG 126 leaves open to licensees the option of under-insuring, in part because ASIC promotes self-assessment, and in part because the factors required to be considered are themselves discretionary.

36. In particular, one licensee's calculation of the above factors in respect of a particular financial product or strategy might differ substantially from another licensee's calculations in respect of the same product or strategy.

37. We consider the danger of such uncertainty to be heightened in the case of more complex financial products such as margin loans and other leveraged investments, and other less-understood financial products such as collateralised debt obligations (**CDOs**) and contracts for difference (**CFDs**).

38. In the case of these complex products, our experience has shown that licensees often underestimate their clients' level of risk exposure. There have been numerous instances where the aggregate amount of loss sustained across a licensee's entire client base in the event of investment failure substantially exceeds the level of coverage available. We have been instructed by Storm Financial (**Storm**) clients that they were regularly told by the authorised representatives of the licensee that, for their investment strategy to fail, "the entire economy would have to collapse." The global financial crisis (**GFC**), while certainly devastating in its impact on financial market, falls dramatically short of this level. We consider that Storm Financial, in assessing the possible economic fallout from its double-geared investment strategy, dramatically underestimated the level of risk to which its clients were exposed.

39. A further concerning feature of leveraged investment products is that there is less obvious correlation between the annual amount of licensee revenue and the total amount of client losses. Licensee revenue is the primary variable recommended by RG 126 as a means of determining whether adequate insurance will sit at the lower or upper end of the coverage range. In a case such as Storm Financial, which provided highly streamlined "one size fits all" investment advice recommending double-geared investment, the amount of the licensee's revenue was relatively small in comparison to the amount of loss sustained by clients in the wake of the licensee's collapse.

40. We consider that ASIC's regulatory guidance would be substantially improved by providing more detailed guidelines regarding the relationship between particular investment products and strategies and the level of adequate insurance coverage. While ASIC has sought to tighten the regulation of licensees promoting margin loan products, currently its regulations do not establish any relationship between the level of gearing recommended to retail clients and the amount of insurance coverage deemed appropriate. Further, we recommend that

ASIC provide more specific guidance on a product-by-product basis, including in respect of geared managed funds, CDOs, foreign exchange contracts and all derivative products.

Suggested reforms

41. We support the development of standard insurance policies for licensees. We understand that previous negotiations between ASIC, the insurance industry and professional bodies in the past did not to lead to agreement on the form of such a policy. An alternative may be for the Government to legislate minimum requirements for all professional indemnity insurance policies.

42. Moveover, it is imperative that reforms in this area, at least, result in better disclosure of insurance arrangements to consumers. We have too regularly seen clients in a situation where they cannot pursue their loss because the licensee is no longer operating, and they have no way of obtaining useful information about the insurance position of the licensee (other than by making a Court application). We support reforms that would result in the following:

    a. disclosure by licensees of their insurance coverage arrangements at the time that a licensee is retained by an investor. In particular, there should be a requirement to disclose the identity of the insurer, the monetary limits of cover (and whether that includes defence costs), the period of cover, the level of any excess, whether the policy has run-off cover, and the types of claims that are excluded from the policy;

    b. where any of the above details change, there should be a requirement for this to be disclosed to clients. The use of online delivery, as proposed at paragraph 5.92 of the Consultation Paper, would enable this to be done at relatively little cost to the licensee.

    c. better direct access for investors to insurance policies where the licensee has ceased operating, is in liquidation or otherwise cannot be contacted. This should include a right for an investor to access a copy of the policy of insurance where the insurer seeks to deny coverage under a policy.

43. At paragraph 5.33 of the Consultation Paper, you note:

    Professional indemnity insurance only assists a licensee in meeting a client's claim where the licensee's policy is still effective and responds to the claim in question. ASIC acknowledges that the insurance cover currently available in the market is unlikely to provide a source of funds where a licensee has become insolvent before the claim was brought. It also recognises 'that insurers may exclude some areas of cover in policies for risk management reasons'.

44. It is these areas of exclusion that we propose the last resort fund be directed. Specifically, compensation under such a fund should be available in circumstances where the licensee has become insolvent and there is no professional indemnity insurance policy in place, the policy in place is not sufficient in size to cover the claim, or the claim is rejected because it falls within an exclusion to the policy (e.g. there was fraud on the part of the advisor).

45. We make the following suggestions in response to some of the specific issues outlined at 5.107 of the Consultation Paper in respect of a proposed last resort fund:

    a. Eligible claims: we agree that claims should be limited to circumstances where a licensee has ceased trading, is insolvent or otherwise unable to meet a claim by an investor (including because such a claim is excluded under any relevant insurance policy). In respect of the latter, this would only work effectively if there were standard requirements for insurance contracts – otherwise, there is potential for insurance policies to include numerous exclusions to shift the burden of recovery to the fund.

    b. Capping of claims: we do not consider that claims should be capped. In the majority of cases, claims are unlikely to be substantial. In this regard we note that UK's

experience is that most claims fall comfortably below the maximum limits for claims.[2] Accordingly, we do not consider that the protection of the integrity of the proposed fund necessitates or justifies limiting the capacity of investors to recover the full amount of their loss. If a cap is introduced, the fund should have the ability to separately compensate multiple claims arising from the same advice in appropriate cases.

c. Liability standard for claims: eligibility should not be limited to a breach by a licensee of Chapter 7 obligations. We often represent clients who do not strictly meet the definition of retail client (which is separately being reviewed as part of the FOFA review) but run near identical claims based on breach of the common law of negligence or contract. We agree that limiting eligibility to cases where there has been a breach of a law, rather than an industry standard, is sensible.

d. Relationship to current compensation arrangements: we agree that a last resort fund should operate only as a second level of protection behind current compensation avenues (FOS and litigation) and recovery sources (the licensee and professional indemnity insurance).

e. Relationship to EDR schemes and the legal system: we do not think it would be appropriate for the proposed fund to conduct a further review of an EDR award or Court judgment. Such a need would not arise if the fund exists only as a source of compensation where a FOS determination or Court judgment has been made.

We thank you for the opportunity to provide comment on the above issues. Please do not hesitate to contact us if you require any further information.

Yours faithfully

Ken Fowlie
Executive Director
SLATER & GORDON

[2] Financial Services Authority, 'Financial Services Compensation Scheme: Review of Limits' consultation paper 08/15, October 2008.