



06 July 2012

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

Email: futureofadvice@treasury.gov.au

Dear Ms Lim

RE: COMPENSATION ARRANGEMENTS FOR CONSUMERS OF FINANCIAL SERVICES

The Financial Services Council (“FSC”) represents Australia's retail and wholesale funds management businesses, superannuation funds, life insurers, financial advisory networks, trustee companies and public trustees.

The Council has over 130 members who are responsible for investing more than \$1.8 trillion on behalf of 11 million Australians. The pool of funds under management is larger than Australia’s GDP and the capitalisation of the Australian Securities Exchange and is the fourth largest pool of managed funds in the world. The Financial Services Council promotes best practice for the financial services industry by setting mandatory Standards for its members and providing Guidance Notes to assist in operational efficiency.

The FSC welcomes the opportunity to respond to the Report by Richard St John, *Compensation arrangements for consumers of financial services*, as part of the Future of Financial Advice (FoFA) reforms.

The FSC welcomes Richard St John’s report on “*Compensation arrangements for consumers of financial services*” and supports St John’s view that it is inappropriate to consider a statutory compensation arrangement at this time.

The FSC firmly believe that a balanced approach which minimises moral hazard, incentivises licensees to be responsible for their own actions and avoids cross-subsidisation will deliver the most appropriate compensation arrangements, without giving rise to unintended consequences or market distortions.

Our submission re-states the FSC’s outline of various options, if required, to enhance the current framework as well as our views on the merits of a statutory compensation scheme together with specific responses to the recommendations raised by St John’s April 2012 Report.

Please find our submission enclosed. We look forward to discussing the contents with you. If you have any questions regarding the FSC's submission, please do not hesitate to contact me on (02) 9299 3022.

Yours sincerely



CECILIA STORNILO
SENIOR POLICY MANAGER



FSC SUBMISSION

***Future of Financial Advice (FoFA) –
Compensation arrangements for consumers of financial
services***

6 July 2012

1. INTRODUCTION

The FSC welcomes Richard St John's report on "*Compensation arrangements for consumers of financial services*" and supports St John's view that

"it would be inappropriate, and possibly counter-productive, to introduce a more comprehensive last resort compensation scheme to underpin the current relatively light compensation regime"¹.

The FSC acknowledges and supports the scope within which the St John review was undertaken. That is, as is presently the case, a retail client whose investments underperform will not give rise to a claim for compensation against a financial adviser or financial services provider unless the investment can be attributed to inappropriate advice or other relevant misconduct by the financial service provider.

We also believe it is important that statutory compensation arrangements are well understood by consumers and do not result in retail clients of financial services providers taking greater risks than they otherwise would.

As is acknowledged by the Report, there are a number of limitations with the current compensation framework that means it has not always been able to meet compensation claims awarded to consumers.

Importantly, however, in the vast majority of cases where consumers have been awarded compensation we believe the current arrangements, underpinned by professional indemnity insurance ("PII"), have provided the necessary financial support to enable claims to be met.

In our view, the current arrangements represent an appropriate foundation upon which the current shortfalls can be addressed and consumer protection enhanced. In some respects the regulator is already addressing these shortfalls particularly with regards to enhancing financial resource requirements of participants in the industry. The FSC's support and comments with regards to the recommendations made by St John to enhance the existing framework can be found in chapter 5 of this paper.

In respect of the level of compensation that should be available, we strongly concur with Treasury in that:

Compensation arrangements are intended to provide an appropriate level of protection but without imposing an unjustified burden on participants in the sector or increased risk-taking either by the investor or the licensee.²

Consequently, the FSC rejects the introduction of a compensation scheme on the basis that:

- It will increase moral hazard by removing incentives for licensees and consumers to be responsible for their own actions.
- Introduces cross-subsidisation between licensees.

¹ Richard St John, *Compensation arrangements for consumers of financial services*, April 2012, page iii

² Treasury submission to the Parliamentary Joint Committee on Corporations and Financial Services' inquiry into Financial Products and Services in Australia, August 2009, page 33.

- Imposes an unreasonable cost burden (1% of revenue) on well capitalised and prudent licensees that already have the means to meet any compensation claims that arise in relation to their dealings with retail clients.
- Financial resources in the form of capital requirements remain a matter for current review by APRA and ASIC. Indeed, ASIC has already increased financial resource requirements for responsible entities. Similarly, APRA is reviewing the current financial resource requirements for superannuation funds. In its latest draft prudential standards it has suggested that RSE licensees maintain adequate financial resources to address losses arising from operational risks within their business operations.
- Future of Financial Advice (“**FOFA**”) will increase the duty an adviser owes their client in the form of a Best Interest Duty and together with the Tax Agents Services Reform will also result in higher standards of advice (education requirements will be raised resulting in enhanced competencies for those advisers operating under the full AFSL regime).

For ease of reference, if a compensation scheme is still to be considered, the FSC previously recommended³ consideration be given to a range of options, all of which build on rather than replace existing arrangements. In summary, these options include:

- Development of a “top up” group professional indemnity insurance (“**PII**”) policy covering those instances where compensation is deemed appropriate but which are not generally covered or available to particular industry participants through the PII insurance market (eg runoff cover, fraud committed by an individual licensee). This group policy would achieve the objective of ensuring a licensee is able to compensate retail clients in the event of a breach and where the offending licensee has ceased trading, become insolvent or otherwise has insufficient assets or compensation is not available under a licensee’s individual PII policy. The policy would be ‘activated’ once all other avenues of recovering the compensation from the offending licensee had been exhausted; and
- Enhancing the financial adequacy requirements of (advice) licensees: This approach will mean that participants in the financial services industry have more of their own funds at risk in the event of a breach, better aligning the interests of consumers and financial services providers.

Irrespective of these or alternative options being considered, the FSC strongly supports the continuation of the existing licensee exemption from compensation arrangements for APRA regulated entities and those entities guaranteed by an APRA-regulated parent company.

In summary, we firmly believe that a balanced approach which minimises moral hazard, incentivises licensees to be responsible for their own actions and avoids cross-subsidisation will deliver the most appropriate compensation arrangements, without giving rise to unintended consequences or perverse market distortions.

³ FSC submission to Richard St John’s Review of Compensation arrangements for consumers of financial services, June 2011

2. ADDRESSING THE GAPS IN PROFESSIONAL INDEMNITY INSURANCE

As outlined above, the FSC understands that current compensation requirements outlined in section 912B of the Corporations Act are being satisfied largely through PII held by licensees.

The FSC has previously raised concerns with PII coverage and arrangements, including that:

- Conditions and exclusions in PII policies can limit the availability of compensation to clients;
- Disclosure of PII arrangements to consumers by way of a summary is of limited value to clients because of the complex nature of the policy wordings;
- Clients losing avenues for redress within the EDR scheme and access to compensation where licensees cease to trade for various reasons and thus cease to hold a license; and
- The ease with which licensees can cease trading and avoid their responsibilities to consumers.

In order to address a number of these issues, the FSC recommends that consideration be given to the creation of a group 'PII gap policy'. The following framework provides an outline of how such a gap policy could operate:

1. All AFS licensees would have a legal obligation to take out the group gap PII policy, subject to the existing licensee exemption from compensation arrangements for APRA regulated entities and those entities guaranteed by an APRA-regulated parent company.
2. As a gap policy, it would only cover insolvency, runoff cover and potentially fraud.
3. Premiums for the policy would reflect risk (i.e. could be based on a number of factors including the number of complaints received by a Licensee and previous claims experience) but with some premium constraints (i.e. a level of cross subsidisation) if a pure risk rating approach would result in affordability problems for large numbers of licensees.
4. The deductible amount for individual policyholders could be linked to capital adequacy of the licensee or other risk factors such as previous claims experience.
5. The policy should only pay out on eligible claims as a last resort (i.e. where all other avenues of recovering the compensation from the offending licensee have been exhausted).
6. Claim limits should apply, as is presently the case under ASIC RG 126 'Compensation and insurance arrangements for AFS licensees'.
7. The group gap policy would not replace a licensee's obligation to hold adequate PII cover in their own right.
8. The group gap policy could be privately underwritten on a tender basis or if the PII market were deep enough, written by existing insurers as an add-on to existing PII cover.

In the event the Licensee were to become insolvent, the appointed external manager (such as an administrator or liquidator) would liaise with retail clients and the issuer of the PII gap policy to manage any claims that may have arisen as a result of the insolvency. Where a licensee sells their business to another licensee, the PII gap policy would either be transferred to the acquiring licensee or the acquiring licensee would be required to amend their existing PII gap policy to reflect the change in their business.

We believe that there are a number of potential benefits to this approach which merit further examination. Fundamentally, this approach ensures that compensation will be forthcoming in circumstances where today individual PII cover may not be available or adequate.

Additionally, this approach does not give rise to significant cross-subsidisation by more prudent licensees and also avoids moral hazard as financial services providers will still be required to maintain their own PII cover and the premiums for the group gap policy would reflect risk.

3. ENHANCING FINANCIAL ADEQUACY REQUIREMENTS

The FSC concurs with St John's recommendation to the Minister and notes that significant changes to the capital requirements to improve the levels of financial resources held by Responsible Entities ("REs") and superannuation funds have been (or are being) made.

For example, ASIC finalised the new financial resource requirements for REs (managed investment schemes) in November 2011. By 1 July 2012, the financial resource requirements for REs will be for them to hold the greater of:

- 10% of the average RE revenue (uncapped);
- 0.5% of the average value of scheme property (capped at \$5 million);
- \$150,000.

Similarly, as indicated above, in its latest draft prudential standards APRA has suggested that registrable superannuation entities ("RSE") licensees maintain adequate financial resources to address losses arising from operational risks within their business operations.

These changes are significant as it means that the providers of superannuation and managed investment products will be subject to higher levels of capital requirements than in the past. In relation to financial advice, the FSC agrees with St John's recommendation regarding a Scheme. However, we submit that it is preferable to enhance the financial adequacy requirements of advice licensees over the introduction of a scheme. Enhancing the financial adequacy requirements will assist to ensure that:

- Licensees (advice providing licensees) have sufficient financial resources to conduct their financial services business in compliance with the Corporations Act;
- there are increased incentives for AFSL holders to act prudently and comply with the Corporations Act; and
- there is a legislated minimum financial buffer available to compensate consumers in the event the licensee is no longer a going concern.

It is also important to highlight that this approach has a number of benefits over the introduction of a statutory compensation scheme (Scheme). Compared to a Scheme, enhancing financial adequacy requirements will minimise moral hazard by relying on self-provision and avoid cross-subsidisation both between different providers in the same industry segment and different providers across different industry segments.

Financial adequacy framework

The FSC recognises that all compensation arrangements inevitably create barriers to entry. In this context, a balance needs to be struck between raising financial adequacy requirements to such a level that competition is inappropriately affected versus setting financial adequacy requirements too low and therefore not materially enhancing consumer protection.

Importantly, the FSC is not advocating for full prudential supervision which addresses a wide range of risks in determining the level of capital that is required to be held by a financial institution.

Instead, the FSC suggests that the recent proposals with respect to the financial resource requirements of Responsible Entities ('ASIC Consultation Paper 140 Responsible Entities: Financial Requirements') should be considered as a possible benchmark in this area.

Aligning the two frameworks will provide efficiency benefits to participants engaged in both types of activities and will also deliver consistency and remove any arbitrage opportunities.

Whatever framework is developed it should apply to all advice AFSL holders and/or providers of financial services,⁴ be easy to understand and apply in practice and not give rise to market distortions or arbitrage opportunities.

The details of any framework will need to be the subject of detailed consultation with industry. The FSC would be pleased to work with the Government on the development of any framework.

⁴ Certain financial services providers are exempted from holding an AFSL. These providers should not be excluded from these or any other compensation arrangements unless they can demonstrate comparable statutory requirements already apply to them elsewhere. If they are excluded, it will provide an incentive for unscrupulous providers to operate on the fringes at a lower cost and subject to less scrutiny.

4. ASSESSING THE MERITS AND OPERATION OF A COMPENSATION SCHEME

Overview

The FSC has long had strong reservations about the merits of a compensation scheme (“Scheme”). We have raised our objections a number of times in relation to various Scheme proposals over the years.

Our principal concerns with the creation of a Scheme relate to the:

- counterproductive signals it sends participants in the industry and consumers;
- entrenched cross-subsidisation;
- doubling-up of compensation arrangements – particularly for more prudent financial services providers; and
- adverse impact on the cost of advice.

In addition to these concerns, we have a number of operational and design related concerns which are detailed below.

Scheme parameters

The following points are made to assist in any recommendations which the Review may provide to government on the potential design parameters of a Scheme. We reiterate that the FSC does not support the introduction of a Scheme, even if it were to meet with the parameters outlined below.

1. Jurisdiction

The jurisdiction of any Scheme should mirror the operation of Section 912B of the Corporations Act. This provision makes it very clear that Licensees need *only* have arrangements for compensating retail clients for losses they suffer as a result of a breach of their obligations in Chapter 7 of the Act.

Critically, compensation for investment losses, lower than expected investment returns or as a result of the insolvency of the Licensee without a corresponding breach of Chapter 7 of the Act are not (and should not be) grounds for compensation. These are legitimate investment and commercial risks which investors take on in a market economy.

2. Coverage

Clients of financial services providers which are not AFS licensees and which have therefore not contributed to the Scheme should not be able to avail themselves of the Scheme.

This is particularly relevant to:

- Superannuation funds which provide financial advice (either personal or general) and which may not hold an AFS License in all cases. These funds should either be compelled to contribute to a Scheme or otherwise be excluded – with the consequence that their retail clients would not be eligible to claim under the Scheme.
- Accountants, lawyers or others and any unlicensed financial advice they may provide.

3. Capping claim amounts

Were a Scheme to be introduced, the FSC strongly recommends it be capped in percentage and absolute terms to mitigate against moral hazard and ensure the Scheme is affordable.

We note that Treasury in its submission to the 2009 Parliamentary Joint Committee Inquiry stated that “expectations may be unreasonably high that all losses would be covered. This is not realistic or appropriate.”⁵

In our view, a percentage cap is important as it conveys to consumers that their financial decisions are not completely risk free – notwithstanding the existence of a Scheme. Similarly, an absolute cap highlights to investors that beyond a certain amount, they are solely responsible for their own investment decisions.

Capping of claims also limits the industry-wide cross-subsidisation which is inherent in any Scheme. Putting an upper cap on claims also effectively reduces the funding requirement on the industry.

4. Interaction with EDR

Monetary limits

The FSC does not support the alignment of any cap that would apply to claims under a Scheme with EDR monetary limits.

EDR exists to provide retail consumers with a cost effective (free) and relatively expedient mechanism to have financial services complaints resolved outside of the formal legal system. The vast majority of complaints resolved by the Financial Ombudsmen Service (“FOS”) relate to licensees that remain a going concern.

The FSC does not therefore believe there is a justification to link any cap that would apply to claims under a Scheme with EDR monetary limits, given a Scheme would exclusively be dealing with complaints relating to now insolvent licensees.

Status of EDR determinations and influence on EDR decision making

From a financial services provider perspective, knowledge that a Scheme has the capacity to meet any compensation order made by an EDR body may result in EDR judgments being more likely to recommend in favour of consumers.

For this reason, the FSC believes that any Scheme should have its own monetary limits, be separately administered and subject to its own Terms of Reference.

The industry already has a number of concerns with the operation of EDR bodies at the moment which would only be exacerbated if those bodies were directly involved in the oversight or management of any Scheme.

⁵ Treasury submission to the Parliamentary Joint Committee on Corporations and Financial Services inquiry into Financial Products and Services in Australia, August 2009, page 36.

The overarching concern FSC members have frequently raised is the lack of transparency and accountability of EDR schemes.

As you may be aware, since the change from FICS to FOS, members have lost the right to vote to change the Rules. While previously allowed under the FICS Constitution, this right was removed when the FOS Constitution was established.

As a consequence, apart from the ability to remove the FOS Board, there are limited mechanisms available to Licensees to ensure accountability at FOS.

Another concern that has been raised relates to the cross-over between the Superannuation Complaints Tribunal and FOS. The industry's view is that on a number of occasions FOS has asserted its jurisdiction where the complaint was more properly within the purview of the SCT.

A number of other procedural concerns have also been raised over time, with the majority failing to be addressed by FOS. These are wide ranging concerns that cover the charging structure employed by FOS to the experience of Case Managers and their suitability to manage complaints.

The FSC would be pleased to provide you with a number of previously lodged submissions on these concerns.

5. Priority of claims

The FSC believes there should be a clear 'priority of claims' in respect of how compensation should be funded where a complainant has been awarded compensation via EDR or formal legal proceedings.

In our view, the 'priority of claims' should be as follows:

- Alternative compensation arrangements should be exhausted (such as PII cover where available).
- If there is no PII cover or it is insufficient, the offending financial services provider must meet the claim/s out of its own reserves – irrespective of whether this forces the provider to become insolvent.
- Finally, only the net amount, if any, should be funded from the Scheme up to a cap – as discussed above.

While this process may delay the payment of some part or all compensation, it is critical to ensure that moral hazard is minimised. Financial services providers should be responsible for breaches they commit and should not be "let off the hook" by virtue of a Scheme.

6. Other schemes

Correspondence with a number of UK based organisations has highlighted the following concerns with the UK Financial Services Compensation Scheme (FSCS).

Cross-subsidies

Under the FSCS, there are a number of pools (deposit takers, general insurers, life insurers, investment firms and mortgage firms) and these, except for the deposit pool, are further divided between providers and intermediaries. Each pool and sub-pool has an annual levy limit which sets the maximum amount which that sector can be levied annually.

There are cross-subsidy arrangements between the different sub-pools in the same larger pool and between the pools. Therefore, if the amount of compensation incurred by an individual pool exceeds its annual limit then the other pools will be levied to make up the difference. These cross-subsidy arrangements mean that it will be possible for a failure in one sector to result in other parts of the industry being levied to pay the compensation.

The FSC does not support this approach. Any classes should be quarantined and levies determined on a risk-weighted basis.

7. Funding model

The creation of a Scheme will require both initial and ongoing funding to meet establishment costs and support its ongoing activities as well as the payment of claims.

In a Scheme proposed by FOS in 2009, it was suggested that “all AFS licensees will be responsible for funding payments in respect of approved claims...[and also] meet the operating costs.”⁶

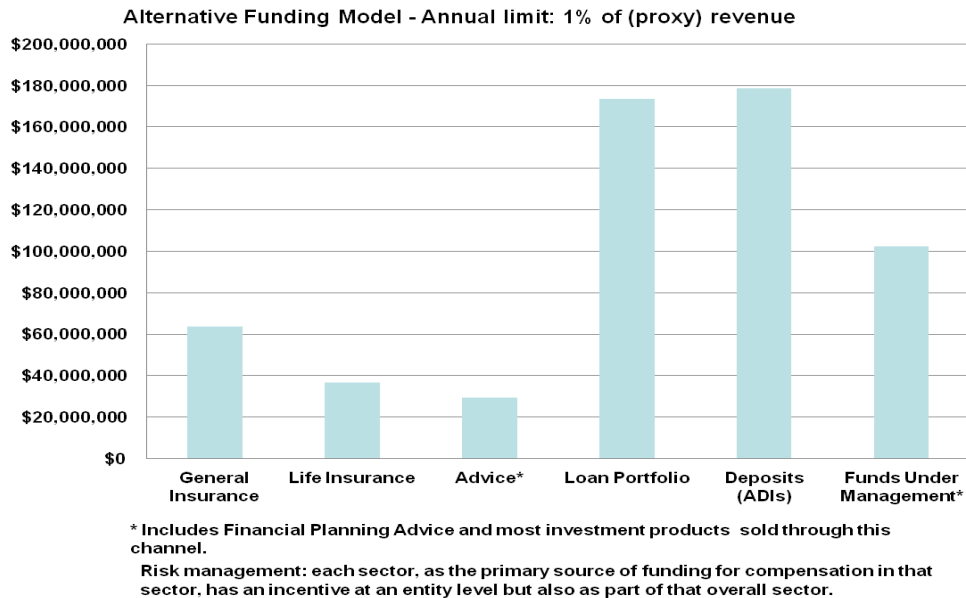
According to the 2009 FOS proposal, the costs to be borne by AFS licensees in Year 1 would amount to \$14.3 million. In subsequent years, FOS assumes operating costs of \$1.2 million. The FSC believes this is a gross under-estimate of ongoing operating costs – particularly if the Scheme is operated independently of Government (that is, Treasury or ASIC) and FOS.

Significantly, the Scheme design initially proposed by FOS involved a levy framework ranging from a \$250 minimum to a \$150,000 maximum levy per year. More recent FOS proposals have advocated a maximum levy of 1% of revenue – potentially uncapped.

The chart below highlights the expected impact on various sectors, as estimated by Professional Financial Solutions.⁷

⁶ ‘Proposal to Establish a Financial Services Compensation Scheme’, Professional Financial Solutions Pty Limited, October 2009.

⁷ Source: Presentation to FSC Board by Peter E Daly AM, Chairman, Financial Services Compensation Scheme Pty Ltd and Martin Fitzpatrick, Principal, Professional Financial Solutions.



The FSC believes that this levy framework will not address the critical issues identified in our submission with respect to cross-subsidisation or moral hazard.

Based on the figures proposed by FOS, the \$150,000 levy (or 1% of revenue) would apply on an ongoing basis, meaning larger Licensees would effectively pay a minimum of \$150,000 per year for the life of the Scheme. The FSC believes this is excessive, disproportionate and effectively results in the cost of the Scheme falling on well governed and well capitalised Licensees that already have the means to meet any compensation claims that arise in relation to their activities.

An additional funding issue arises where due to a large scale collapse, the levies required to fund any awarded compensation would need to be staggered over a number of years in order to avoid a potentially significant and unexpected revenue cost to innocent providers.

Layering of compensation arrangements

As has already been highlighted, the existence of a Scheme is unlikely to displace existing PII cover or the capital that is increasingly being required to be held by prudentially regulated entities.⁸

Any funding model therefore needs to address these issues in a manner which avoids doubling up and which allows for Licensees to meet any enhanced requirements through alternative means.

This could be partially addressed by exempting APRA regulated entities from the operation of the Scheme.

This approach reflects current government policy whereby under the Corporations Regulations, general insurance companies, life insurance companies and authorised deposit-taking institutions regulated by APRA are exempt from the compensation requirements.

⁸ APRA 'Level 3 Conglomerate proposals' will cover conglomerate funds management and superannuation activities.

5. RECOMMENDATIONS IN DETAIL

Richard St John: <i>Compensation Arrangements for consumers of financial services</i> Report recommendations	FSC view
<p>1. Last resort scheme</p> <p>Recommendation 1: Last resort scheme It would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage.</p>	<p>Strongly support.</p>
<p>2. Strengthen current compensation arrangements</p> <p>Recommendation 2.1: Licensees to demonstrate adequacy of their insurance Require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs.</p>	<p>Support in principle.</p> <p>Consultation on the assurances ASIC would require would be required including guidance from ASIC on what it considers to be adequate PI insurance (e.g. coverage, exclusions etc), and the consequences of a shortfall in cover (e.g. if adequate PI cover could not be obtained). Any guidance that ASIC provides on the adequacy of PI insurance arrangements should be in consultation with financial services industry participants and PI insurance providers.</p> <p>Note that existing arrangements for prudentially regulated bodies corporate and their related entities should continue in their current form and be excluded from this proposal.</p>
<p>Recommendation 2.2: Licensees to hold appropriate capital resources More attention should be given, on a risk targeted basis and in conjunction with the level of their insurance cover, to the adequacy of licensees' financial resources to enable better management of risks and unexpected costs such as compensation liabilities.</p>	<p>See comments provided in the paper. Product issuers to hold appropriate capital resources. Advice providers to demonstrate adequacy of insurance arrangements. Further, alignment and appropriate consideration where licensees are already subject to prudential regulation and other capital requirements.</p>
<p>Recommendation 2.3: A more pro-active stance by ASIC ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate professional indemnity insurance cover and any new requirement in regard to financial resources, and in targeting licensees who are most at risk.</p>	<p>Support in principle as per recommendation 2.1</p>
<p>Recommendation 2.4: Policing the licensing system in regards to compensation To assist ASIC in playing a more pro-active role in administering the licensing regime with respect to compensation arrangements, consideration should be given to clearer powers to enforce standards and to sanction licensees who do not comply through:</p> <ul style="list-style-type: none"> • powers to deal with phoenix activity, both through licensees establishing new entities or by former directors who re-emerge in the industry as authorised representatives; • ability to deal with disreputable industry participants; and • access to an infringement notice regime. 	<p>FOFA has been enacted: ASIC powers have been enhanced and are effective from 1 July 2012.</p>

<p>Recommendation 2.5.1: Compensation where licensees cease to trade In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business.</p>	<p>Support in principle. Further consultation is necessary to understand how this would work in practice.</p>
<p>Recommendation 2.5.2: Protection from unlicensed providers There are risks to consumers where they deal with financial services providers that:</p> <ul style="list-style-type: none"> • have a licence, but operate beyond the scope of that licence because they provide products or services that are not covered by the licence; or • should be licensed under the Corporations Act but are not, <p>and accordingly have limited or no compensation arrangements.</p> <p>While acknowledging the difficulties in identifying outlaw activity, the importance of concerted enforcement effort by ASIC to police the boundaries of licensed financial service activities is emphasised. In its approach to the handling of complaints about outlaw activities ASIC should be transparent and provide as much feedback to complainants as possible in order to encourage further assistance.</p>	<p>Support in principle. FSC submits that focusing on preventative measures may be a more efficient use of ASIC’s resources.</p>
<p>Recommendation 2.5.3: Third party rights under licensee’s insurance policy (a) Where a licensee (or its administrator or liquidator) does not respond to claims from a consumer or the licensee cannot be contacted after reasonable inquiry, ASIC should be able to provide the consumer with information it has about the insurance policy including the name of the insurer and the policy number. This would assist the consumer to decide whether there is a prospect of recovering compensation should the claim proceed and be successful.</p> <p>(b) The third party rights provisions of the <i>Insurance Contracts Act 1984</i> should be extended, as was proposed by a review of that Act in 2004, to apply where a consumer cannot recover compensation awarded against the insured and there is capacity to meet that liability from the insured licensee’s professional indemnity insurance policy.</p>	<p>Support.</p> <p>Support in principle. Further consultation is necessary to understand how this would work in practice</p>
<p>Recommendation 2.5.4: Defence costs ASIC should give further consideration, in its approach to the adequacy of professional indemnity insurance cover, to the treatment of defence costs with a view to striking a reasonable balance between the interests of licensees and insurers on the one hand, and consumers on the other.</p>	<p>Do not support. Any consideration by ASIC of the adequacy of PI insurance, and any regulatory guidance that it issues in this regard, should take into account the impact on the accessibility of PI insurance and its cost, and any result that would effectively mean large, financially secure licensees underwriting the defence costs of claims involving smaller, riskier licensees. Consultation with financial services industry participants and PI insurers is critical</p>
<p>Recommendation 2.5.5: External Dispute Resolution scheme processes Given their key role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims. Issues for consideration include: rights of</p>	<p>See the FSC recommendations regarding EDS noted on page 18.</p>

<p>review; transparency; capacity of a member to join in a proceeding other members that might be liable; cost contribution by complainants; liability standards; relevance of regulatory guidance and other operational issues discussed in Chapter 2.</p>	
<p>3. Rebalance responsibilities of licensees</p> <p>Recommendation 3.1: Review regulation of product issuers As a matter of strategic approach, it would be timely to review the present relatively light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach.</p> <p>(a) Subject product issuers to more positive obligations in regard to the suitability of their product for retail clients.</p> <p>(b) Consider the development of standardised product labelling so that financial products, particularly managed investment schemes, are described on a consistent and more meaningful basis.</p> <p>(c) While the review has not looked into these matters in any depth, the significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.</p>	<p>Do not support.</p> <p>FSC submits ASIC has completed this review and issued on 7 November 2011 through Class Order (CO 11/1140]) and outlined in updated versions of Regulatory Guide 166 Licensing: Financial requirements (RG 166) and Pro Forma 209 Australian financial services licence conditions (PF 209), aim to ensure REs have adequate resources to meet operating costs and there is appropriate alignment with the interests of investors</p> <p>ASIC has issued a number of disclosure regulatory guides for MIS providers to improve consumer understanding about the product and enhance protection (benchmark reporting). For example RG 231: Infrastructure entities: Improving disclosure for retail investors</p> <p>Further, the FSC submits it is not appropriate for a product provider to determine the <i>suitability or appropriateness</i> of a product for the consumer (in the manner in which say a financial adviser is required by law). We submit that the product provider already carries obligations to disclose the nature and risks of the product and other information to inform and enable the consumer to determine if it's the right investment for them. We believe that consumers are able to seek financial advice to further assist them and it is the role of financial advisers to determine the appropriateness of a product for a consumer in light of their relevant personal circumstances. The recently introduced FOFA reforms contain measures that are designed to improve the quality of financial advice.</p> <p>Requiring product providers to determine suitability would be another regulatory overlay and burden for which consumers would ultimately pay –for no corresponding enhancement to consumer protection. Instead we believe resources would be better spent via ASIC's educational programs for consumers like MoneySmart on concepts such as risk vs return.</p> <p>On 16 November 2011, ASIC issued <i>Consultation Paper 171 Strengthening the regulation of research report providers (including research houses)</i> (CP 171) which proposes research report providers, including research houses, separate their business units as a strategy to manage conflicts of interest as part of moves to improve confidence in the independence and quality of research reports.</p>

<p>Recommendation 3.2: Responsibility of product issuers through EDR schemes</p> <p>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 amongst responsible licensees. The operating rules of EDRs should be changed to enable them to make awards that recognise the proportionate liability of product issuers, financial advisers or other licensees.</p> <p>Further, consideration should be given to the clarification of clause 5.1(i) of the terms of reference of FOS which excludes consideration of disputes about the ‘management of the fund or scheme as a whole’. The aim would be to remove any doubt about the ability of FOS to deal with consumer disputes in respect of misleading product disclosure statements or other practices of issuers in marketing their products.</p>	<p>See the FSC recommendations regarding EDS noted below.</p>
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External Dispute Resolution

The FSC’s supports the role of external dispute resolution schemes (“**EDR schemes**”) in providing consumers with an avenue outside the court process and internal dispute resolution to seek to resolve disputes. The relevant EDR scheme for FSC members is the Financial Ombudsman Service (“**FOS**”). FSC has an open, professional, facilitative and constructive relationship with FOS, which FSC appreciates. FOS regularly liaises with, and consults with, FSC in relation to matters within FOS’s remit.

An external dispute resolution service necessarily involves a trade-off between cost, flexibility and procedural safeguards. FOS is not a court, and the jurisdiction (created in contract and by the Australian financial services licencing regime) of FOS to make awards in favour of a consumer extends beyond the situation where a financial services provider has breached a legal requirement; that is, FOS may also have regard to industry practice and what is fair in the circumstances when making a determination. FOS can award up to \$280,000 (for investment matters) and hear claims for up to \$500,000.

The St John report noted (at page 47) that:

“2.181 It appears that more attention needs to be given to underlying issues of due process and transparency in the context of the expanded jurisdiction of EDRs in order to maintain confidence in the system and contain any undue cost burden on the provision of financial services.

2.182 There will always be some trade-off between the provision of low cost, flexible dispute resolution services for consumers and ordinary procedural and due process safeguards. The answer may lie in the provision of somewhat more rigorous and transparent processes for claims for compensation in excess of a reasonable monetary threshold. I suggest that issues of the kind noted above call for further consideration including by EDR schemes themselves and ASIC in its overview role.”

The St John report (at page 50) also assessed in the context of EDR schemes:

“... it is noted that EDRs such as FOS play a key role in the regime for the protection of consumers of financial services. They provide a relatively informal process through which consumers can bring complaints against licensees at no cost to themselves. They play a valuable role in this regard. At the same time, EDRs are not cost free to member licensees or to the provision of financial services to consumers. A note of caution is sounded about elements of their operation and processes as they grow beyond their origins as forums for resolving small claims. Issues of the kind noted in paragraph 2.180 call for further consideration including by EDR schemes themselves and ASIC in its overview role.”

FSC agrees with, and supports, Mr St John’s comments above in respect of EDR schemes.

FOS can award up to \$280,000 (for investment matters) and hear claims for up to \$500,000. The amounts which may be awarded by FOS (and which may be awarded beyond situations where a financial services provider has breached a legal requirement; but having regard to what is fair in the circumstances and industry practice) are now well beyond “small claims” amounts.

FSC recommendations

1. FSC recommends that in relation to amounts in excess of a “small claims” monetary threshold (but below the FOS jurisdictional monetary limit) in respect of FOS decision making, there be additional procedural safeguards, more rigorous (i.e. less informal) processes, and additional transparency processes, including a rigorous review and appeal mechanism.
2. This submission does not seek to land on what may be the amount (beyond “small claims” amounts) beyond which additional review/appeal mechanisms should apply nor what those additional review/appeal mechanisms may consist of in addition to current FOS processes.
3. We consider that Government (or Treasury) should consult with all stakeholders (including ASIC, FOS, consumers, FSC, and financial services providers/EDR scheme members) in respect of assessing and reviewing decision making processes (including additional review and appeal rights) for non-“small claims” amounts brought to FOS. Without landing on a “small claims” limit in this submission, it is suggested that figures in excess of \$100,000 are significant sums of money and may well be a proxy for amounts which should be subject to additional review/appeal mechanisms.