INQUIRY INTO COLLAPSES IN THE FINANCIAL SERVICES INDUSTRY

SUBMISSION BY FINANCIAL OMBUDSMAN SERVICE ("FOS")

Introduction

This is the submission by FOS to the Inquiry by the Parliamentary Joint Committee on Corporations and Financial Services into the underlying issues concerned with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses. The submission has been prepared by the office of FOS and does not necessarily represent the views of the board of FOS.

This submission draws on the experience of FOS and its predecessors in dealing with disputes concerning financial services providers.

Information about FOS

FOS commenced operations on 1 July 2008. It is an independent dispute resolution scheme that was formed through the consolidation of three schemes:

- the Banking and Financial Services Ombudsman ("BFSO");
- the Financial Industry Complaints Service ("FICS"); and
- the Insurance Ombudsman Service ("IOS").

On January 2009, two other schemes joined FOS, namely:

- the Credit Union Dispute Resolution Centre ("CUDRC"); and
- Insurance Brokers Disputes Ltd ("IBD").

FOS is an external dispute resolution ("EDR") scheme approved by ASIC. Membership of FOS is open to any financial services provider carrying on business in Australia including providers not required to join a dispute resolution scheme approved by ASIC. Replacing the schemes previously operated by BFSO, FICS, IOS, CUDRC and IBD, FOS provides free, fair and accessible dispute resolution for consumers unable to resolve disputes with financial services providers that are members of FOS.

Members of BFSO, FICS, IOS, CUDRC and IBD are now members of FOS. The members of those schemes included:

- BFSO – Australian banks and their related corporations, Australian subsidiaries of foreign banks, foreign banks with Australian operations and other Australian financial services providers;
- FICS – life insurance companies, fund managers, friendly societies, stockbrokers, financial planners, pooled superannuation trusts, timeshare operators and other Australian financial services providers;
- IOS – general insurance companies, re-insurers, underwriting agents and related entities of member companies;
- CUDRC – credit unions;
- IBD – insurance brokers, underwriting agents and other insurance intermediaries.

It is estimated that FOS covers up to 80% of banking, insurance and investment disputes in Australia. As well as its functions in relation to dispute resolution, FOS has powers to identify and resolve systemic issues and obligations to make certain reports to ASIC.

FOS is a not for profit organisation governed by an independent board with consumer representatives and financial services industry representatives.

FOS operates under published Terms of Reference that require FOS to provide an independent and prompt resolution of disputes having regard to:

- the law;
- applicable industry codes or guidelines;
- good industry practice; and
- fairness in all the circumstances.

How submission has been prepared and presented

FOS has received disputes linked with recent collapses of financial services providers, including disputes relating to advice to invest in Westpoint mezzanine funds and lending for Storm Financial investments. However, we have only completed investigations and made determinations in some of these disputes. Many disputes considered by FOS are resolved by negotiation or conciliation.

FOS has not completed an investigation of any dispute linked with Storm Financial. Even in cases linked with Westpoint, where the collapse occurred some time ago, only about 30% of disputes received have been fully investigated and determined by FOS. A relevant factor in this context is that our Terms of Reference prevent us from dealing with disputes involving financial services providers that have gone into liquidation before lodgement of the disputes. FOS may deal with a dispute lodged before a liquidation, but a determination by FOS is not enforceable against a liquidator.

Where possible, we have used information relating to disputes linked with recent collapses in preparing this submission. We have also used information relating to other disputes – especially disputes that have been fully investigated by FOS. The information and comments in this submission, which relate to some, but not all, of the issues to be examined in the Inquiry, are presented below under the following headings:

- Westpoint;
- Margin Lending and Other Forms of Credit;
- Licensing;
- Obligations under the *Corporations Act 2001* (the "Act"); and
- Professional Indemnity Insurance.

Submission

1. Westpoint

General obligations under section 912A of the Act

As at 1 May 2009, FICS and FOS had received 442 written complaints relating to advice to invest in Westpoint products. Determinations had been made in respect of 79 of the complaints. In 42 of the 79 determinations, a breach of the general obligations under section 912A of the Act was found to have occurred. The breaches of general obligations that feature most prominently in these determinations are breaches of:

- the obligation to ensure that financial services are provided efficiently, honestly and fairly;
- the obligation to have in place arrangements to manage conflicts of interest; and
- the obligations to supervise authorised representatives.

This information about non-compliance, in our opinion, indicates that the regulatory arrangements to ensure compliance with the general obligations under section 912A – particularly the obligations listed above - may need to be reviewed.

Whether products are within the Act's "financial product" definition

Westpoint formed the view that certain promissory notes issued by Westpoint entities were not within the Act's definition of "financial product". Relying on Westpoint's view, some financial services providers promoted and sold the notes without observing the requirements imposed by the Act for financial products. The Supreme Court of Western Australia considered promissory notes issued by a Westpoint mezzanine fund in *Australian Securities and Investments Commission v Emu Brewery Mezzanine Ltd* [2004] WASC 241. The court decided, in November 2004, that the promissory notes were "interests in a managed investment scheme" as defined by section 9 of the Act, and therefore "financial products" as defined in the Act. Based on the court's analysis, financial services providers that had relied on Westpoint's view had contravened various provisions of the Act that apply to financial products. So legislative requirements designed to protect consumers were not met.

The question of whether a product amounts to a "financial product" as defined in the Act is a legal question that may sometimes be difficult to be determine. We are concerned that, if this question is answered incorrectly, consumers may suffer as, for example, Westpoint investors have suffered. We think that steps could be taken to reduce the likelihood of this scenario arising. It may be possible, for example, to provide more guidance on the definition of "financial product" and its significance. Another approach would be to devote more resources to surveillance of practices in regard to products that may, incorrectly, be characterised as falling outside the definition of "financial product".

2. Margin Lending

We note from information provided in relation to disputes that a financial planner may sometimes complete the loan documents for margin lending or other forms of credit on behalf of a client and ask the client to sign the documents. In this situation, the client may not work through the documents, which contain important material such as acknowledgements and information about risks. It may be advisable for a client to take time to review material in the documents or discuss the material with another person before signing. For example, in some cases, clients should consult their accountants before committing to margin lending.

We also note that in certain instances where disputes have arisen, disputants have alleged that loan documents completed by financial planners contain inaccurate information about their clients' financial position.

The current regulatory regime is predicated on the fact that consumers must have an opportunity to thoroughly read, check and consider documents before signing them. It is widely recognised, however, that consumers do not always read documents that they sign. By imposing additional requirements around the method of completion of documents for complex arrangements such as margin lending, it may be possible to reduce inaccuracy in information and improve the likelihood of consumers being alerted to risks.

3. Licensing

We are concerned about the situations outlined below, which we have come across in our dispute resolution work. In these situations, we understand that clients of financial services providers were left with uncompensated losses after the providers went into liquidation or underwent restructures. Authorised representatives of the financial services providers continued in the industry.

- A financial planning company was placed into voluntary liquidation after FICS and FOS resolved several disputes against the company in favour of its clients. Clients did not receive full compensation. We believe that the former staff of the company went on to operate a new financial planning company from the old company's premises.

- Several disputes were brought against a financial planning company. The company sold its client list and assets to a competitor. It seems, however, that the company's liabilities were not transferred. The company rebranded itself and remained in the financial services industry.

- The purchaser of the client list referred to above traded under the vendor's original name after the sale. Several disputes were then brought against the purchaser. It was placed into voluntary liquidation and clients were unable to recover full compensation from either the purchaser or vendor. The staff of the purchaser moved to new premises and established a new financial services business.

- A licensee was found by FICS, in multiple disputes, to have misappropriated client funds. The licensee was placed into voluntary liquidation. Its sole director remained in the financial services industry as an authorised representative of another licensee for some time after the misappropriations before being banned by ASIC for 6 years.

Generally, ASIC can only make a banning order against a person after giving the person an opportunity to appear or be represented at a hearing and to make submissions on the matter. For the current regime to protect consumers, ASIC has to have highly effective ways to obtain information about threats to consumers and have the resources required to conduct any necessary investigations and hearings promptly.

In our view, ASIC should investigate any case where authorised representatives remain in the industry after leaving their clients with uncompensated losses and should expedite the investigation and any necessary hearing in such a case. If these steps are not taken quickly, the risk of further losses to clients increases. We acknowledge, of course, that it may be difficult to identify all of these cases promptly and that limits to resources limit investigation programs and may result in slower hearings.

Measures may need to be introduced to make it easier for ASIC to identify situations of the type outlined above. For instance, an authorised representative moving to another licensee could be required to provide ASIC with information about past activities that would highlight involvement in financial losses. A simpler alternative may be for ASIC to make greater use of the information that it receives about authorised representatives moving between licensees. Licensing arrangements may also need to be reviewed to ensure that they require licence applications to include sufficient information about past activities of proposed authorised representatives.

4. Obligations under the Act

Knowledge and understanding of existing obligations

Since September 2007, FICS and FOS have made determinations in 88 financial planning disputes. In 44 of those determinations, the financial services provider needed to receive an explanation of the liability of the licensee for the conduct of its authorised representatives (which is one of the more straightforward aspects of the licensing regime). This suggests that a significant number of financial planners do not have an adequate knowledge of their obligations under the Act. If this is the case, it appears to us that there are likely to be deficiencies in areas like training and supervision of authorised representatives, for which the Act makes licensees responsible. It may be necessary to provide more guidance on the obligations of licensees or to take more intensive surveillance and enforcement action to work towards a position where licensees meet satisfactory standards.

It has become apparent from various disputes that some authorised representatives believe that the research requirements imposed by section 945A of the Act may be fulfilled by simply using information in an independent research report. In several cases, total reliance was placed on a report that stated that it should not be relied on to provide all the information necessary for investment decisions. The section 945A

requirements were not met in these cases. This information suggests to us that authorised representatives may not be trained adequately at present and the requirements relating to training may need to be reviewed.

Other areas that may require review

FICS and FOS have received disputes in regard to general advice to invest in products that resulted in substantial losses to consumers. Our records do not enable us to provide statistics to indicate how often investments made on the basis of general advice result in losses or to identify the consumers most severely affected by the losses. Nevertheless, these disputes prompt us to raise the question of whether licensees should be prevented from providing general advice about particularly risky investments to the group of investors for which risky investments are least suitable. Such a measure may reduce the likelihood of investors in this group being advised to invest in unsuitable risky investments.

The requirements that have to be met when providing financial product advice vary according to whether the advice is personal or general advice. We consider that it may sometimes be difficult to meet these requirements in practice. For example, an authorised representative may set out to provide general advice only in a meeting, but, during the course of the meeting, provide personal advice (because at some point the representative suggests that the client's objectives, financial situation or needs have been considered). In our assessment, the current financial services legislation requires the authorised representative in this situation to be extremely skilful and knowledgeable. He or she has to recognise, while advising a client and employing selling techniques, that the line between general and personal advice has been crossed and meet the more onerous requirements for personal advice after crossing the line. If licensees were prevented from providing general advice in certain circumstances, some flexibility would be lost, but some of the complexity of compliance referred to above would be removed. This could be expected to make it easier for licensees to satisfy obligations in areas such as training and supervision of authorised representatives.

The Act requires a product disclosure statement ("PDS") to contain information that may be detailed and complicated. In our experience, it is quite common for someone to invest in a financial product without reading its PDS or after reading the PDS without understanding crucial material in it. We believe that this is because the documents are, for many consumers, too long and technical to read. Our experience confirms that a shorter, simpler disclosure document setting out the most important information might be more likely than a PDS to be read and understood by potential investors. This shorter, simpler document along the lines of a "key features statement" could incorporate additional, less important, information by reference.

5. Professional Indemnity Insurance

FICS commented on the adequacy of professional indemnity ("PI") insurance, as a compensation mechanism for consumers, in its:

- submission to Treasury in December 2006 on draft regulation 7.6.02AAA on "Regulation for Compensation for Loss in the Financial Services Sector"; and

- submission in September 2007 to ASIC's *Consultation Paper 87 – Compensation and Insurance Arrangements for AFS Licensees.*

Copies of these submissions are attached.

As explained in the submissions, through its dispute resolution work, FICS identified inadequacies in PI insurance for financial services providers and their clients. Concerns that FICS articulated in its submissions are now concerns of FOS. They are noted in simplified terms below.

- PI insurance, which is designed to protect the policy holder, may not serve the purpose of a compensation mechanism.

  A financial services provider's clients are able to claim under the provider's PI insurance only in the limited circumstances provided for in section 51 of the *Insurance Contracts Act 1984*. Normally, where a client's dispute is upheld by an EDR scheme, the client will be unable to directly seek payment from the PI insurer and will have to rely on the cooperation of the financial services provider, or its administrator or liquidator.

- Conditions and exclusions found commonly in PI insurance policies relieve insurers from obligations to make payments in situations that may give rise to disputes that FOS may consider.

  Examples of such conditions and exclusions include:
  - monetary limits on liability;
  - excesses payable by financial services providers;
  - limits on liability in respect of EDR disputes; and
  - exclusions of claims relating to products not on financial services providers' approved product lists.

  It is not suggested that insurers should or could be required to provide cover on terms dictated by section 912B of the Act and the related regulation 7.6.02AAA. However, FOS is concerned that, unless PI insurance is sufficiently broad and free of exclusions to completely or at least substantially cover disputes between financial services providers and their clients, either or both of the following outcomes will occur:
  - Financial services providers will not be able to satisfy the conditions of their licences, due to inability to obtain PI insurance that is "adequate" for the purposes of regulation 7.6.02AAA;
  - The requirement in regulation 7.6.02AAA for PI insurance to be "adequate" will in practice become less onerous than it was intended to be, reflecting the limitations of PI insurance that insurers are willing to provide. The effectiveness of EDR will be undermined if financial services providers cannot pay financial compensation awarded by EDR schemes.

- PI insurance may not expressly provide cover for outcomes of EDR.

If a PI insurance policy does not expressly provide cover for outcomes of EDR, the PI insurer may effectively disregard an EDR settlement or determination in respect of a dispute and make its own decision about liability.

- Disclosure of PI insurance arrangements to clients of financial services providers is of limited value due to the complexity of the arrangements.

  A simple summary of a PI insurance policy may be insufficient or misleading. However, most consumers are unlikely to understand the details of a PI insurance policy, which may be vital in the event of a claim. It appears unrealistic to us to expect clients of financial services providers to form a view as to the adequacy of their providers' PI insurance.

- PI insurance may not provide adequate "run off" cover for activities undertaken while a financial services provider holds its licence.

  A particular concern is the scenario where a financial services provider ceases to trade without satisfying responsibilities to clients and its PI insurance provides no, or inadequate, "run off" cover.

The collapse of a financial services provider, Deakin Financial Services Pty Ltd ("Deakin"), illustrates some of the concerns referred to above. As a result of advising 190 clients to invest in Westpoint products, Deakin had a potential exposure of $21.9 million. It went into administration in November 2007. Deakin had PI insurance, but its PI insurance policy contained exclusions to relieve the insurer from the obligation to indemnify Deakin in respect to some of the compensation that it may have had to provide to clients. The insurer and administrators settled the insurance claim on the basis that $5.95 million was paid to avoid litigation. The settlement money was distributed between the clients whose claims were accepted by the administrator.

The submissions by FICS referred to above advocated a centralised compensation fund, which was Option 4 in ASIC's Consultation Paper 87. For the reasons stated in those submissions, FOS now supports the establishment of a fund to provide a safety net for consumers of financial services.

Summary of Submission

This submission presents information and comments based on our dispute resolution experience. The submission:

- highlights areas in which compliance with the Act may not be satisfactory, including compliance with the general obligations of licensees under section 912A;
- explains FOS's concerns about the adequacy of PI insurance as a compensation mechanism for consumers; and
- discusses conduct and practices in the financial services industry that may have an adverse impact on consumers and more broadly, such as –
    - licensees going into liquidation or restructuring, leaving clients with uncompensated losses, while authorised representatives involved in the losses continue in the industry,

    - documents for complex arrangements like margin lending being completed in a way that may not give consumers opportunities to read, check and consider the documents thoroughly,
    - products being characterised incorrectly as falling outside the Act's definition of "financial product", and
    - providing general advice in cases where the stronger protections that the Act gives in regard to personal advice may be needed.

In this submission, we suggest steps that could be taken to address issues identified. The steps include:

- introducing measures to improve compliance with existing regulatory requirements;
- changing those requirements to -
    - make it easier for ASIC to perform its role in licensing,
    - replace the PDS with a shorter, simpler disclosure document,
    - address problems stemming from the way in which documents for financial products are completed; and
- establishing a compensation fund.

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The Manager – Investor Protection Unit
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The Treasury
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Dear Manager,

SUBMISSION IN RELATION TO DRAFT REGULATION ENTITLED "COMPENSATION ARRANGEMENTS FOR FINANCIAL SERVICES LICENSEES"

Introduction

1. The Financial Industry Complaints Service ("FICS") is an External Dispute Resolution ("EDR") Scheme in the financial services sector, approved by the Australian Securities and Investments Commission ("ASIC") pursuant to Policy Statement 139. FICS is a company limited by guarantee, with a representative Board comprising of four industry and four consumer Directors and an independent Chair. FICS deals with written complaints first by attempting to conciliate the complaint, but if this is unsuccessful, the client has the option to have his or her complaint determined by an independent Panel or Adjudicator.

2. FICS deals with complaints in relation to life insurers, financial planners, stockbrokers, managed investments and friendly societies. FICS also has other members who operate within the financial services sector such as Futures and Options dealers. The membership consists of a wide range of financial service providers, from very large bank owned entities to single practitioner businesses.

3. FICS considers it would be helpful for it to comment upon the draft regulation and the impact paper in order to share its experiences of the problem being discussed. This may assist in placing the proposed arrangements into the context of the nature and size of the problem to be addressed.

4. In preparing this submission, FICS has had regard to, and been assisted by, the following documents:

    - The proposed regulation, dated 2 November 2006 ("The Regulation");
    - The Draft Regulation Impact Statement, dated 2 November 2006 ("The Impact Statement");
    - The Issues and Options Paper, dated 6 September 2002 ("The Issues Paper");
    - The Position Paper, dated 24 December 2003 ("The Position Paper");

- The Financial Services Consumer Policy Centre (November 2002 and March 2004), and FICS (2002);
- The Corporations Act 2001 ("The Act"), specifically s. 912A and B;
- The Australian Securities and Investments Commission Act 2001 ("The ASIC Act"), specifically s. 12;
- The related regulations of The Act and The ASIC Act;
- The Insurance Contracts Act 1984 ("The 1984 Act"), specifically s. 51; and
- The FICS Constitution and Rules, as at 1 January 2007

Executive Summary

5. An evaluation was conducted of the following topics:

    - The problem faced by the industry and the market;
    - The objectives of the current discussion and reforms;
    - The five options put forward by the Draft Regulation Impact Statement, dated 2 November 2006, along with an impact assessment from the point of view of FICS; and
    - The drafting of Draft Regulation 7.6.02AAA.

6. The issues that FICS is predominantly concerned with are:

    - 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;
    - The ease with which licensees can cease trading and avoid their responsibilities to consumers;
    - The conditions and exclusions in Professional Indemnity Insurance (PI) Policies severely limit the availability of compensation to clients;
    - Any regime adopted must recognize approved EDR schemes' jurisdiction, processes and awards of compensation;
    - Disclosure of PI Insurance arrangements to consumers by way of a summary is of limited value to clients because of the complex nature of the policy wordings.

7. FICS submits any requirements adopted must encompass compensation for clients in the circumstance where they have dealt with a licensee but, for whatever reason, that licensee has ceased to hold a licence. The experience of FICS in relation to Westpoint complaints in particular demonstrates just how easy it is for a licensee to avoid any responsibility by simply winding up the entity, or leaving it as an empty shell.

8. FICS has concerns in relation to PI Insurance as the preferred option because PI Insurance is designed as a protection for a licensee and is not designed to be a client compensation mechanism. In the FICS experience PI Insurance policies have been inadequate due to the policy terms and conditions excluding many of the behaviours that have given rise to the complaint.

9. In addition PI insurers have, to date, demonstrated an unwillingness to embrace EDR processes, often providing no or modified cover for EDR decisions, and FICS is concerned at the way in which several insurers have responded to the Westpoint claims by vigorously resisting the jurisdiction of FICS.

10. As a minimum, any requirements adopted must recognize the jurisdiction, processes and awards of compensation of approved EDR Schemes such as FICS.

11. FICS submits that the proposed safeguard of disclosing PI insurance arrangements to clients is of limited value. PI Policies are complex documents and any attempted summary of the cover is likely to be insufficient or misleading due to the complex nature of the policies. The details of the policies, which will be vital in the event of a claim, are unlikely to be understood by the ordinary consumer.

12. For the above reasons FICS prefers a centralized fund (option 4). This option can make provision for compensation in circumstances where a licensee has ceased trading. As the purpose of the fund would be the provision of compensation to clients the failings of current arrangements and PI Insurance as detailed in this submission would be overcome.

13. The next preferred option is option three; PI insurance with detailed prescription.

14. If option two were to be adopted then FICS suggests that the draft regulation could be improved by including in Paragraph (2) in relation to adequate cover words such as; "taking into account the insuring clauses and any conditions, exclusions and excesses."

Consideration

The Problem

15. The Impact Statement identifies the problem as being that financial services licensees are not always in a position to meet claims made against them, out of their own resources, leaving open the possibility that retail clients may not obtain adequate payments of compensation claims.

16. In response to the Issues Paper, ASIC reported that there had been cases where clients had suffered significant losses and were unlikely to receive compensation payments. The Impact Statement states that these occurrences tended to involve licensees whose insurance did not provide relevant cover, no insurance existed or the assets of the business were insufficient to cover claims.

Objectives

17. The Impact Statement states that the objective of this consultation is to reduce the risk that compensation claims to retail clients cannot be met by the relevant licensees due to lack of available financial resources.

18. It is noted that the objective is a reduction of the risk, not an elimination of the risk, and this would seem to be feasible and appropriate. The scope of any such reduction has not been detailed.

Option 1 – Do Nothing

19. This option leaves the determination of what is adequate arrangements for compensating retail clients for loss or damage suffered because of breaches of the relevant obligations

under Chapter 7 of the Act, as per s. 912B (1) of the Act, to the licensee to determine, as no regulation would be in place to prescribe those arrangements, as considered by s. 912B (2).

20. There is an alternate methodology for some guidance for licensees, being written approval of such arrangements by ASIC. Administratively, given that ASIC covers almost 4,500 AFS License holders, it would not be feasible to expect ASIC to be able to adequately review and approve schemes in relation to each licensee.

21. Unless specific arrangements are mandated, the prospect of a client recovering a successful award or settlement would depend on the solvency and prudence of the individual licensee.

22. Whilst this approach offers flexibility to licensees, it would place an administrative burden upon ASIC, as the Commission would be required to regularly assess the arrangements adopted by all AFS license holders.

23. In the experience of FICS the current approach has failed large numbers of clients. The failure of this approach has been highlighted by the recent collapse of the Westpoint Group; however there have been a number of other circumstances where clients have been left without redress. Of particular concern to FICS is the comparative ease with which licensees can exit the industry and avoid responsibilities. Any regime which aims to provide for adequate compensation arrangements needs to address this issue.

24. For example, in two recent matters before FICS clients sought to complain about the advice given by an advisor employed by a licensee. The licensee concerned sold its client list and transferred all of its advisors (including the advisor being complained about) to another licensee which is a Member of FICS. The acquiring licensee is refusing to take responsibility for the complaints and the original licensee has had its licence revoked and is no longer a Member of FICS.

Option 2 – Professional Indemnity Insurance (without detailed prescription)

25. This option proposes a regulation that would prescribe PI as one means of complying with section 912B. Although there would be some principles-based requirements for the adequacy of cover, the regulations would not prescribe in detail the type of insurance required. The adequacy of the arrangements would be linked to the licensee's exposure to claims through external dispute resolution bodies and other relevant characteristics of the licensee's business. Licensees would be required to summarise their PI coverage in their Financial Services Guide.

26. One concern with this option is that it relies upon the willingness of PI insurers to provide cover sufficient to meet the purposes of the compensation regime, on terms which are financially affordable to those licensees which require insurance.

27. The FICS experience so far in relation to claims against financial advisors arising out of the collapse of the Westpoint group has revealed significant deficiencies in the coverage of PI policies. It appears that licensees have not been able to negotiate policies that adequately protected their interests. It is unclear whether that inability is a result of the availability of cover, the level of premiums, the competence of the licensee to negotiate appropriate cover or other issues such as the intent of the PI Insurer to minimize liability for itself.

Specific Examples

Deakin Financial Services ("DFS")

28. FICS has received 16 complaints in relation to DFS, which was legally represented and put forward detailed submissions against FICS having the jurisdiction to handle complaints against the company and in respect of Westpoint in general.

29. Following a FICS Panel Ruling finding that FICS had jurisdiction and setting out its reasons for such, DFS threatened legal action and injunctive measures to prevent FICS from handling the complaint.

30. FICS issued proceedings to enforce its jurisdiction, but two working days after the hearing, on 8 November 2006, DFS announced that it had placed itself into administration. As a result of s. 440D of the Act, it is unlikely that legal proceedings may be brought directly against DFS by aggrieved clients, and so their only options are to bring a complaint to FICS, or to await the outcome of the administration.

31. According to the administrator, DFS has very few assets which are outweighed by its established liabilities, as well as currently having received complaints from 66 clients to date with a combined potential exposure of $8.65 million. The total potential exposure is $21.9 million, as a result of 190 clients being advised to invest in Westpoint.

32. DFS will be seeking to rely upon its PI insurance to meet any established compensation claims. The cover provided by the policy is likely to be inadequate.

33. Clients of DFS therefore have no other practical recourse but to await the administrator / liquidator's outcome.

34. This PI Policy which is discussed in detail, as it is in the public domain, contains a number of exclusions which are likely to relieve the insurer of liability to indemnify the licensee in respect of circumstances which would commonly give rise to a complaint to FICS.

35. Examples from that contract which would leave the licensee uninsured against a successful complainant include:

    - Maximum liability of $100,000.
        - Complaints of up to $250,000 about advice in relation to Life Insurance products are within the FICS Rules. While the upper limit for non-life-insurance complaints is currently $100,000, this does not include interest or costs, which can currently be awarded up to $50,000 or $2,000 respectively.
        - FICS currently applies the monetary limit to the amount of the redress sought by an individual complainant and FICS could therefore accept multiple complaints arising from the one event, each individually under $100,000 but totalling in excess of $100,000, but clause 6.7 of the policy apparently limits the insurer's liability to $100,000 in respect of an event regardless of the number of claims arising from it;
    - Excess ("deductible") of $100,000 applying to claims against the licensee and $18,750 for claims against an authorised representative.

    - It is unclear which deductible would apply to a complaint to FICS as even if a complaint is about the conduct of an authorised representative the complaint at FICS must be brought against the licensee.
    - Complaints to FICS other than those relating to life insurance are currently limited to a maximum $100,000, not including interest, so one interpretation of the policy is that the cover for most complaints to FICS is the same as the deductible;
- Liability in respect of FICS complaints limited to an aggregate of $200,000.
    - FICS has to date, in the one period of insurance received multiple complaints against DFS, and of those complaints which appear to fall within FICS' jurisdiction the total liability if all complaints were upheld would be in the order of $1.2 million;
- Defining a single claim by reference to a causal event rather than by reference to a single claimant
    - See above regarding how this impacts on the adequacy of a $100,000 limit per claim;
- Claims relating to products not on the licensee's approved list are excluded;
- Claims relating to derivatives are excluded;
- Claims relating to services provided as a fund manager are excluded;
- Claims relating to guarantees, warranties or indemnities regarding investment performance or return are excluded
    - This could extend to exclude many complaints of misrepresentation about performance, a common category of complaint to FICS;
- Claims relating to misleading or deceptive conduct other than those in respect of alleged actual misleading or deceptive conduct under ss12DA, 12DB or 12DF of the ASIC Act; and
- Claims relating to computer hardware of software
    - A number of FICS members have been the subject of complaints about the selling of computer programs.

36. While other policies may not necessarily contain these precise limitations and exclusions, they may contain other exclusions which similarly leave a licensee uncovered against a FICS complaint, a complaint to another EDR scheme, or legal action by a client because of the nature of the conduct alleged by the complainant.

Company A

37. Company A had 72 clients whom were advised to invest in Westpoint mezzanine schemes. Company A has advised FICS that its PI cover provides for a $30,000 excess in respect of each of the complaints, (a total of $2,160,000) before any monies would be payable by the insurer. FICS has received three complaints about this Member so far. It would not be unreasonable to suggest that if the licensee receives a significant number of complaints that it would end up in liquidation.

Company B

38. FICS has received 6 complaints in relation to company B's advice to invest in Westpoint, which have a total potential exposure for company B of $799,937.

39. Company B went into administration on 9 August 2006, and subsequently into liquidation on 6 September 2006. The liquidator recently advised that company B had 16 creditors

who had submitted proofs with a total amount claimed of $1,409,579. Whilst company B does have PI insurance, the terms and amount of cover are unknown to FICS at this time. Given that the Company B went into administration expressly as a result of the claims against it involving Westpoint it would be reasonable to assume that the PI cover was inadequate.

40. Whilst the liquidation process is continuing, the principal of company B has been continuing to operate as an authorised representative of another member.

Company C

41. FICS has received 25 complaints in relation to company C's advice to invest in Westpoint. The total potential exposure of company C in relation to the complaints at FICS is $1,966,060.72, and no PI details have been provided.

42. The principal of company C cannot be located and no response has been forthcoming to enquiries either by FICS or, FICS understands, ASIC. ASIC is currently in the process of seeking a winding up order.

43. Again it is reasonable in the circumstances to assume that the PI cover was either non-existent or inadequate.

Company D

44. There are currently 6 complaints before FICS in relation to Westpoint investment advice allegedly having been provided by company D.

45. On 30 June 2003, company D (a) purchased the assets of company D and purports to have contracted out of liability for any advice provided (which includes advice the subject of the six complaints) before the date of sale by way of the sale agreement. Company D (a) maintains to FICS that as the sale agreement is a commercially sensitive document, it will not provide details of the sale to FICS. In addition, company D (a) commenced its AFS License on 1 July 2003.

46. Company D has continued to trade as company D(c), but does not appear to be providing financial services to retail clients and therefore it is not a member of FICS or any other approved EDR scheme.

47. FICS is concerned that unless PI insurers are prepared to offer liability cover sufficiently broad, and sufficiently free of exclusions, to cover the whole, or almost the whole, of any and all complaints received during the period of insurance either or both of two outcomes will occur:

    - Financial services providers will be unable to satisfy their licensing conditions as they cannot obtain insurance cover that is "adequate" for the purposes of the Act and the Regulation; and/or
    - The concept of what is "adequate" cover will be such cover as PI insurers are willing to offer, whether or not that cover falls short of the intent of the s. 912B and its regulations.

48. Neither of these outcomes is desirable. Accepting PI cover as "adequate" when it does not comprehensively indemnify the licensee against all potential claims undermines the

effectiveness of the compensation regime under section 912B. This in turn would undermine the effectiveness of EDR, which depends on a licensee being able to meet any settlement reached.

49. The majority of PI policies confine themselves to "legal liabilities" or contain exclusions regarding assumed duties or liabilities. This requires the PI Insurer to be actively involved in the settlement negotiations, or at the very least to accept their own liability in the even of any settlement, prior to the settlement being reached. Whilst most licensees intending to rely upon PI will be in active discussions with their PI Insurer throughout the course of the EDR process, such involvement may frustrate the equitable resolution of a claim due to the construction of the policy documents.

50. In the majority of cases a successful complainant will be unable to directly seek payment from the PI insurer and is dependent upon the cooperation of the licensee, or its administrator / liquidator, which will not necessarily be forthcoming. The Insurance Contracts Act 1984 and related case law would indicate that it is difficult for complainants to seek redress directly from the Insurer, even when they are named, directly or indirectly, in the insurance policy.

51. Giving complainants the right to directly pursue a claim against the relevant PI insurer could be most effectively done by amendment to, for example, section 51 of the Insurance Contracts Act. In addition, consideration could be given to whether some other mechanism to provide a direct avenue of claim, for example requiring any PI policy to contain a term granting any person who obtains an award or settlement at an EDR scheme direct recourse to the insurer.

52. FICS submits that the proposed safeguard of disclosing PI insurance arrangements to consumers is of limited value. PI Policies are complex documents and any attempted summary of the cover is likely to be insufficient or misleading due to the complex nature of the policies. The details of the policies, which will be vital in the event of a claim, are unlikely to be understood by the ordinary consumer.

53. Furthermore, disclosure of insurance cover, to be adequate, would need to involve provision of a comprehensive summary in the Financial Services Guide.

54. Clients would be unlikely to be able to form a view of how adequately it provided indemnity. This in turn would require the consumer to understand, when acquiring a financial product or service:

    - what might potentially go wrong with that product or service;
    - the extent to which they might be able to claim compensation, i.e. what problems might demonstrate failings on the part of the licensee or for which the licensee might be liable; and
    - the scope of the relevant EDR scheme or schemes.

55. The main problem faced by relying upon PI policies as a compensatory arrangement is that PI policies are designed for the purpose of providing protection to the licensee in the event of the licensee's legal liability for an insured event, subject to policy conditions. The PI industry was developed as a protection for the policy holder, not for the policy holder's consumers, and as such the terminology and case law is of little assistance when a third party is seeking redress.

56. If option two were to be adopted then FICS suggests that the draft regulation could be improved by including wording which provides that in assessing adequacy of cover the policy terms, conditions, exclusions and excesses should be taken into account.This suggestion is based on the experience of FICS in relation to complaints regarding Westpoint where, although the Member has had PI Insurance, the policy terms and conditions will prevent adequate compensation to clients.

Option 3 – Professional Indemnity Insurance (with detailed prescription)

57. This option is the same as Option 2, except that, rather than principles-based requirements regarding adequacy, the regulation would be specific about the details of acceptable professional indemnity coverage. It would, for example, prescribe in dollar terms the amount of coverage required by reference to some attribute(s) of the licensee's business and contain specifics about other key terms of the insurance policy.

58. To the extent that this option, like Option 2, relies on the willingness of PI insurers to provide adequate cover, or of licensees etc to cooperate with a claim on the policy, many of the concerns set out above apply equally here.

59. To the extent that the requirements of adequacy are prescribed in detail, the risk that an insurance policy is accepted as "adequate" when it does not cover all or almost all potential complaints is significantly reduced.

60. This is subject to the coverage required being sufficiently broad to give complete or significant cover in respect of any and all complaints to the relevant EDR scheme(s). If the prescribed requirements do not include cover in respect of EDR schemes such as FICS, then this would undermine the requirements of s. 912B.

61. However, this option has the additional difficulty of stifling competition and innovation between AFS Licensees, introducing a prescribed standard across the professional indemnity insurance industry in relation to financial services, and therefore undoubtedly requiring many licensees to alter the terms of their existing PI insurance policies.

62. There is a risk that some or all PI Insurers may withdraw from the market if the prescribed requirements are not the type and level of cover they are willing to provide.

Option 4 – Centralised Fund

63. This option would require licensees to contribute to a central fund, similar to the ASX funded National Guarantee Fund or the Government's Medical Indemnity Fund, but one that would be dedicated to meeting compensation claims of retail clients under Chapter 7. Such a fund could be created by statute and supported by compulsory levies, or be private schemes run by industry / professional bodies.

64. This option is preferred by FICS. The purpose of the fund would be to compensate clients in the event that a licensee's PI Insurance or existing resources prove to be inadequate and therefore the deficiencies of the current arrangements would be overcome. Of particular benefit would be the ability of such a fund to compensate clients in the event that a licensee ceased to trade. In our experience it is these situations where clients are most at risk and PI Insurance is unlikely to be a suitable mechanism for compensation.

65. Most professions have a form of indemnity fund that is contributed to by its members. For instance, the medical profession has the government sponsored Medical Indemnity Fund and solicitors have the Solicitors Mutual Indemnity Fund.

66. The Government's position is that the costs for industry and the Government itself are likely to be much greater with this option than with Options 2 or 3. If the financial services industry wants to pursue further professionalism then having a centralised fund may be a step towards this.

67. Enforcement of a code of ethics and behaviour is commonly conducted in the recognised professions of law, medicine, engineering etc. through an industry review board and a capability of the industry to compensate consumers for the inappropriate actions of the industry's members.

68. It would therefore logically follow that the financial services industry should consider a similar arrangement to satisfy the interests of its members as a further step in increasing professionalism.

Option 5 – Security Bonds

69. This option would require licensees to lodge security bonds with, for example, ASIC, that could be used to meet compensation claims of retail clients if the licensee was unable to do so.

70. Given that the Westpoint collapse has resulted in approximately 50 licensees recommending to 3,000 clients that they should invest a total of $300-400 million, the average potential exposure is around $6-8 million, but with some dealer groups it has already been shown to be much higher – in excess of $20 million.

71. As an initial outlay, this option will make growth within the industry impossible and will prohibit many of the smaller licensees from trading, undermining competition in the marketplace.

72. Further, for such an approach to provide redress, the security bond would need to be provided on terms which require enough of the bond to be released to meet the licensee's obligations under a settlement or determination, upon provision of that settlement or determination, and without the additional bureaucracy of having to prove an entitlement to compensation to more than one body, for example FICS and ASIC.

Draft Regulation 7.6.02AAA

73. The drafting of the regulation measures adequacy of insurance cover against the highest potential liability a licensee could have in respect of individual claims or total claims for which they may be liable as a result of their membership of the EDR scheme. The current wording therefore addresses the FICS concern that its determinations and adjudications must be recognized.

74. FICS' concern regarding "run-off" cover might be addressed by the wording of ss.(2)(a)(ii), but the rest of ss.(2)(a) makes this unclear. FICS would prefer that the regulation clearly identifies that the arrangements need to be in place to cover all activities undertaken whilst the entity held a financial services licence.

75. FICS suggests that the draft regulation could be improved by including in Paragraph (2) in relation to adequate cover words such as; “taking into account the insuring clauses and any conditions, exclusions and excesses.” This suggestion is based on the experience of FICS in relation to complaints regarding Westpoint where, although the Member has had PI Insurance, the policy terms and conditions will prevent adequate compensation to clients.

76. Given FICS’ concern is with the capacity to repay, the exemption (from the obligation to hold adequate insurance cover) of APRA-regulated general or life insurers, deposit taking institutions, and related licensees in respect of which those entities have provided a guarantee, appears to be reasonably founded.

The Experience of FICS

77. Most recently, the collapse of Westpoint has highlighted the problem of inadequate compensatory arrangements held by AFS Licensees. However, the problem has not been restricted to financial services issues of this magnitude.

78. FICS’ experience, particularly in receiving complaints in respect of advice to invest in Westpoint, is that the number and amount of claims for compensation against a licensee will not always be proportionate to the licensee’s size or solvency.

79. Further, licensees whose compliance regimes are least likely to reduce the risk of breaches of their statutory/license obligations are also, as a general rule, the least likely to put compensation arrangements in place in advance of actual claims unless compelled to do so. There would therefore be a risk that the clients most likely to need to claim against provisions to compensate for breaches would also be least likely to find the licensee’s arrangements sufficient in these circumstances.

80. Options two and three provide a lot of power to the PI Insurers who will be setting the terms of individual contracts, either at their own discretion, or which meet minimum prescribed parameters. Neither option ensures that in the event of a successful claim or complaint, the PI Insurer will accept liability, and as such the direct protection to clients may be limited. The experience at FICS in relation to Westpoint has been that the involvement of PI Insurers has caused significant delays and substantial costs in FICS’ endeavour to handle Westpoint cases.

81. FICS has discussed its concerns with major insurers in an endeavour to find a solution and to avoid the escalating costs but these overtures have not to date achieved any outcomes.

Conclusion and Recommendations

82. Ultimately, adopting the majority of these options will see the client paying an increased price as the industry adjusts its fees and commissions to reflect the added overhead. Likewise, ASIC will inevitably have increased costs through either monitoring or administering whichever option in put in place.

83. Option four; a centralised fund, is preferred by FICS. The purpose of the fund would be to compensate clients in the event that a licensee’s PI Insurance or existing resources prove to be inadequate and therefore the deficiencies of the current arrangements would be overcome. Of particular benefit would be the ability of such a fund to compensate

clients in the event that a licensee ceased to trade. In our experience it is these situations where clients are most at risk and PI Insurance is unlikely to be a suitable mechanism for compensation. This option may need government assistance to establish, and the industry would need clear guidelines as to how the fund was to operate, especially in relation to how contributions or levies would be collected, used and disbursed. This option also places the financial services industry and financial planners in particular in a similar position to other professions.

84. Option three is the option next preferred by FICS. The prescribed minimum requirements could deal with issues such as recognition of EDR scheme jurisdiction, processes and awards of compensation, and cover where a licensee ceases to trade. The issue of direct consumer access to the PI Insurer in these circumstances would also need to be addressed. Protection for consumers would be increased, with the market being able to have confidence that minimum standards must have been met. PI Insurers would need to demonstrate a preparedness to offer cover at the prescribed level for this option to be viable.

85. Option two leaves the decision of what adequate cover is to the licensee in question with minimal guidance provided by the Regulation, and this is where part of the problem has arisen with certain licensees, who have been unable, for whatever reason, to have appropriate PI cover in place. Whilst this may pass on additional costs to the client through increased service fees to allow for the costs of PI insurance, it will not ensure that there is adequate cover in place in the event of a claim. It also does not address the issue of licensees ceasing to trade and consumers thereby losing access to avenues for compensation.

86. If option two were to be adopted then FICS suggests that the draft regulation could be improved by including in Paragraph (2) in relation to adequate cover words such as; “taking into account the insuring clauses and any conditions, exclusions and excesses.” The regulation should also clearly identify that the cover provided by the insurance must be adequate to cover all activities undertaken while the entity held a licence.

Dated this 8th day of December, 2006

Alison Maynard,
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COMPENSATION AND INSURANCE ARRANGEMENTS FOR AFS LICENSEES

FICS SUBMISSION TO ASIC

August 2007

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FINANCIAL INDUSTRY COMPLAINTS SERVICE LIMITED

Executive Summary

The Financial Industry Complaints Service (FICS) welcomes the opportunity to comment on the proposals made by the Australian Securities and Investments Commission (ASIC) for administering the new compensation and insurance obligations on AFS licensees (licensees) set out in ASIC Consultation Paper 87 (Consultation Paper). FICS strongly supports ASIC's approach to consulting with stakeholders prior to finalising its Regulatory Guide.

As an External Dispute Resolution (EDR) scheme in the financial services sector, approved by ASIC pursuant to Policy Statement 139, FICS adjudicates complaints made against licensees. FICS has the power to make awards against licensees in order to compensate retail clients for their losses. FICS' recent experience of the collapse of Westpoint shows that many licensees do not have sufficient financial resources to compensate retail clients.

Most aspects of the Consultation Paper strike a fair balance between the dual objectives of consumer protection and the flexible and efficient regulation of licensees. However, the use of the commercial PI market to meet these multiple objectives poses some challenges. FICS' key recommendations are:

1. **That the Government more closely consider one of the policy options raised in the Regulation Impact Statement to the new compensation and insurance obligations: a centralized fund to supplement PI.**

2. **That the definition of 'adequate PI' be amended so that licensees are required to obtain run-off cover, unless alternative arrangements are approved by ASIC.**

3. **That a 'two-tier' model be adopted by ASIC so that either (a) a licensee forms the view that their PI is 'adequate' based on ASIC's guidance *or* (b) ASIC approves an alternative arrangement. FICS recommends that licensees be required to apply to ASIC for approval of 'partially adequate PI' supplemented by cash-flow as one possible form of an 'alternative arrangement' to 'adequate PI'.**

4. **That licensees should be required to disclose the features of PI set out in the Consultation Paper and that they should be required to do so in plain English that does not unreasonably extend the length of FSGs.**

5. **That if a licensee proposes to use a DOFI to provide PI, that PI should be approved by ASIC. FICS recommends that applications should be made to ASIC, which could perhaps be assisted by APRA, to assess whether PI provided by a DOFI is an approvable 'alternative arrangement' to 'adequate PI'. Normally, 'adequate PI' would be provided by an APRA-authorised insurer.**

FINANCIAL INDUSTRY COMPLAINTS SERVICE LIMITED

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Introduction

This is a submission by Financial Industry Complaints Service (FICS) to the Australian Securities and Investments Commission (ASIC) on ASIC's proposals for administering the new compensation and insurance obligations on AFS licensees (licensees) set out in ASIC Consultation Paper 87 (Consultation Paper).

This submission comprises two Parts. The first Part sets out FICS' key recommendations to ASIC on the implementation of the obligation on licensees to have adequate compensation arrangements. The second Part sets out FICS' response to each of the questions that ASIC has asked stakeholders to answer in its Consultation Paper.

FICS is an External Dispute Resolution (EDR) scheme in the financial services sector, approved by ASIC pursuant to Policy Statement 139. FICS has a representative Board comprising of four industry and four consumer Directors and an independent Chair.

FICS is an independent EDR which considers and seeks to resolve disputes between consumers and members of the financial services industry, including life insurance, managed investments, some friendly societies, financial advice, stock broking, investment advice and sales of financial or investment products. It is an alternative to litigation and free to consumers.

Its members include life insurers, funds managers, friendly societies, stockbrokers, financial planners, pooled superannuation trusts, timeshare operators and other Australian financial services providers. FICS also has other members who operate within the financial services sector such as Futures and Options dealers. The membership consists of a wide range of financial service providers, from very large bank owned entities to single practitioner businesses.

FICS deals with written complaints first by attempting to conciliate the complaint, but if this is unsuccessful, the client has the option to have his or her complaint determined by an independent Panel or Adjudicator.

1. Part 1 – Key recommendations

1.1 Forming a centralized fund to supplement PI as a compensation mechanism

PI is a mechanism for *minimising* rather than *eliminating* the risk that retail clients are not compensated.[1] PI is a tool used by licensees to manage the risk that they will be exposed to liability to their clients. It enables them to remain in business whilst paying those claims. As such, it is the licensee, not the retail client who has a *direct* relationship with a PI insurer. The terms of that relationship are set out in a contract of insurance. Only under the very limited circumstances provided in s51 of the *Insurance Contracts Act 1984* may retail clients have the ability to make a claim under a licensee's PI cover.

As acknowledged by ASIC in its Consultation Paper, there are limitations to PI as a mechanism for consumer protection. If the Proposals contained in ASIC's Consultation Paper are adopted in the Regulatory Guide, then many of the problems with PI will be eliminated or reduced. For example, if licensees are required to have sufficient financial resources to cover the shortfall in level of PI they can obtain, then this will reduce the risk of retail clients going uncompensated if their financial advisor has been unable to find or negotiate a sufficient level of cover in the commercial PI market.

However, a significant gap remains. This is the possibility that retail clients will be uncompensated if the licensee that they deal with becomes insolvent. This may occur where the level of PI is insufficient to meet *catastrophic* losses (such as has been recently witnessed following the collapse of Westpoint), or if licensee is unprofitable for reasons which do not relate to claims made by clients (such as economic downturn or failure to properly manage business).

Westpoint Case Study 1

A former member of FICS, Deakin Financial Services (DFS) is the object of complaints by approximately 100 clients which it referred to Westpoint with a combined potential exposure of

[1] *Compensation Arrangements for Financial Services Licensees Regulation Impact Statement April 2007* (released 29 July 2007)

$16.3m. The total potential exposure is $21.9m as a result of 190 clients being advised to invest in Westpoint.

DFS held a PI policy for the relevant period. Under that policy, the insurer's liability was limited to $100,000 in respect of an event regardless of the number of claims arising from it. Liability in respect of FICS complaints was limited to an aggregate of $200,000.

This policy is clearly inadequate to meet DFS' liabilities. DFS is in administration. Its liabilities exceed its assets and is unlikely to compensate retail clients in full.

To minimise the gap caused by these types of catastrophic losses, FICS believes that a centralized fund should be introduced. In introducing the obligations on licensees to have adequate PI (or alternative arrangements), the Government raised the issue of whether there should be a centralized fund.[2] It concluded that there were benefits to consumers of this option, and that the nature and cost of a centralized fund would 'depend on its ultimately agreed structure and funding'.[3]

There is precedent for a centralized fund, both in Australia and internationally. For example, in each State there is a Fidelity Fund which covers losses sustained by the clients of legal service providers. In the United Kingdom, the Financial Services Authority (FSA) has set up the Financial Services Compensation Scheme (FSCS).

The Council of Financial Regulators (COFR) has recently taken an important step towards protecting retail clients from losses where they have purchased a financial product from a deposit-taking institution, general or life insurer. It has proposed a compensation fund.

FICS submits that a similar fund is warranted for the retail clients of other types of financial service providers.

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[2] *Compensation Arrangements for Financial Services Licensees Regulation Impact Statement April 2007* (released 29 July 2007)

[3] *Compensation Arrangements for Financial Services Licensees Regulation Impact Statement April 2007* (released 29 July 2007) p 26

FICS has undertaken some preliminary research in this field (conducted by Melzan Pty Ltd) and believes that such a fund could be funded by a combination of Federal funding for start-up costs, ASIC support for operational costs and industry costs and industry levies to cover compensation.

FICS believes that the PI provided by the market should be supplemented by a centralized fund with the following key features:

- Coverage of fidelity (fraud and misappropriation of funds) and last resort (insolvency, cease trading, disappearance and loss of license);
- Caps that are on par with EDR scheme financial jurisdiction such as that of FICS;
- Operation by an independent body jointly governed by EDR schemes, consumer representatives, Government and industry representatives;
- Multi-source funding from Government for establishment costs, ASIC for ongoing operating expenses, a borrowing facility combined with post-event levies on licensees;
- Direct access by retail clients to the centralized fund;
- Supported by Federal legislation which ties the obligation on licensees to have adequate compensation arrangements to compliance with their funding obligations to the centralized fund; and
- Prospective application ideally commencing on the same date that the obligation on licensees to have PI commences, currently being 1 July 2008.

Recommendation 1

FICS encourages the Government to more closely consider one of the policy options raised in the Regulation Impact Statement to the new compensation and insurance obligations: a centralized fund to supplement PI.

1.2 Expanding the definition of 'adequate PI' insurance

FICS supports ASIC's proposal to require licensees to obtain PI that has a per claim limit at least as high as the maximum monetary limit that applies to their EDR scheme, however FICS is concerned that this will not be adequate to cover many claims which are pursued in courts. FICS views this level of cover as necessary, but not 'adequate'. Defining such a low level of cover as 'adequate' may be an incentive for licensees to adopt inadequate risk management strategies.

ASIC's proposal is to require the following as key features of an adequate PI insurance policy:[4]

- A per claim limit at least as high as the maximum monetary limit that applies to their EDR scheme;
- Aggregate cover of $2m for licensees with an annual turnover of up to $1m and twice annual revenue for licensees with an annual turnover of more than $1m;
- Cover for loss or damage suffered by retail clients because of breaches of obligations under Chapter 7 of the Corporations Act;
- Cover for breaches by both the licensee and its representatives;
- Cover for awards made by the EDR to which the licensee belongs;
- *as far as possible*, it must continue to provide cover for a period of time after the licensee ceases business (run-off).

FICS generally supports this Proposal, although believes that run-off is an *essential* feature of an 'adequate' policy. The period for which run-off is available is currently available appears to be one year.[5]

Consistent with Recommendation 3, if a licensee is unable to obtain PI which has run-off cover, that policy would be inadequate and an application would need to be made to ASIC for approval of the licensee's 'alternative arrangements'.

In the alternative, if the Government adopts FICS' Recommendation 1 for a centralized fund to supplement the role of PI to properly protect consumers, then it may not be necessary for ASIC to approve PI that does not include 'run-off'. Ideally a centralized fund would provide funds for retail clients whose financial advisors have ceased trading, lost their license or otherwise disappeared.

[4] Consultation Paper Proposal B4

[5] Consultant's Report delivered by Melzan Pty Ltd 'Compensation Arrangements for Financial Services Licensees' December 2006 pp48-49

Although the proposed aggregate cover (of $2m for licensees with an annual turnover of up to $1m and twice annual revenue for licensees with an annual turnover of more than $1m) will be sufficient for many licensees in most circumstances it will not be sufficient for the kinds of *catastrophic* losses sustained during the Westpoint collapse. The Westpoint collapse has resulted in approximately 63 licensees recommending to 3000 clients that they should invest a total of $300-$400m.The average potential exposure is around $4.75-6.5m.

The proposed aggregate cover levels would be sufficient if the centralized fund referred to in Recommendation 1 is introduced.

Recommendation 2

That the definition of 'adequate PI' be amended so that licensees are required to obtain run-off cover, unless alternative arrangements are approved by ASIC.

1.3 Requiring partially adequate PI to be approved by ASIC

ASIC proposes a three-tiered model for PI, being 'fully adequate' PI, 'partially adequate' PI with the remaining liability being self-funded and approved 'alternative arrangements'. The proposed 'three-tier' model allows licensees to determine whether their PI is 'partially adequate' and, if so, decide that any shortfall be made up by cash-flow.

FICS supports ASIC's proposal to allow licensees to assess whether they have 'adequate' PI or to apply to ASIC for approval of 'alternative arrangements' to 'adequate' PI. That is, FICS supports a 'two-tier'.

In FICS' submission, self-insurance arrangements and self-insurance combined with inadequate PI should be approved by ASIC.

The key reason for this recommendation is that even with ASIC's guidance, it can be very difficult for licensees to make an adequate assessment of their own risk profile. An inaccurate assessment exposes retail clients to the risk that claims will not be paid. For example, the FICS' experience of the recent collapse of Westpoint, one licensee which is a Member of FICS had approximately 80 clients with exposure to Westpoint. That licensee held a PI policy, however the excess for each claim was $30,000. This left a very significant shortfall. If all 80 claim, it becomes very likely that the licensee will become insolvent.

This example demonstrates that there is an important role for ASIC in approving whether cash-flow can meet the shortfall of partially adequate PI and that there is a role for a centralized fund to cover the kinds of catastrophic losses that characterised the Westpoint collapse.

This submission reflects the structure and intent of the new regulations,[6] which require licensees to have 'adequate' PI or obtain approval from ASIC.[7]

Although FICS understands that this places a significant obligation on ASIC to approve the arrangements developed by licensees, FICS is of the view that this is an important investment in consumer protection.

Recommendation 3

That a 'two-tier' model be adopted by ASIC so that either (a) a licensee forms the view that their PI is 'adequate' based on ASIC's guidance *or* (b) ASIC approves an alternative arrangement. FICS recommends that licensees be required to apply to ASIC for approval of 'partially adequate PI' supplemented by cash-flow as one possible form of an 'alternative arrangement' to 'adequate PI'.

1.4 Strengthening the disclosure requirements

FICS supports the requirement to disclose to retail clients that the licensee holds PI and some of the limitations of PI. Given the nature of FSGs at present, FICS submits that this disclosure should be made in plain English so as to not unreasonably extend the length of FSGs.

FICS sees disclosure as part of a broader framework for consumer protection. Even disclosure in plain English may be too complex for some retail clients. Disclosure should not be seen as sufficient consumer protection in and of itself. For this reason, FICS re-iterates Recommendation 1.

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[6] *Corporations Amendment Regulations* 2007 (No 6).

[7] *Corporations Amendment Regulations* 2007 (No 6) 7.6.02AAA (1), (2)

Recommendation 4

FICS recommends that licensees should be required to disclose the matters set out in the Consultation Paper and that they should be required to do so in plain English that does not unreasonably extend the length of FSGs.

1.5 *ASIC approval of PI obtained from DOFIs*

Direct Offshore Foreign Insurers (DOFIs) are insurers that are not prudentially regulated by APRA.

APRA regulates insurers by, amongst other things, setting minimum standards for capital and for risk management. These measures assist in ensuring that an insurer is adequately capitalised to meet its liabilities to licensees. This minimises the chance of an insurer being unable to pay compensation claims made by retail clients.

Importantly, if COFR's proposal for a compensation fund to assist policy-holders of APRA-authorised insurers progresses, there will be even less chance that a licensee will be unable to claim under their policy. In recognition of the importance of regulation by APRA, the Government has announced that it will regulate some direct offshore foreign insurers (DOFIs).[8] It will be some time before this regulation commences. In the interim, there is a risk that licensees will obtain PI from an unauthorised DOFI.

The risk that DOFIs pose to licensees (and therefore to retail clients) is that if they do not pay a claim, it is very difficult for a licensee to take action against them, and that if they become insolvent,

[8] http://assistant.treasurer.gov.au/pcd/content/pressreleases/2007/042.asp

it is almost impossible to recover. It is very difficult for an individual licensee to determine whether a particular DOFI is reliable and has the necessary financial resources to pay claims,

FICS believes that this assessment should be made by ASIC, perhaps with assistance from APRA.

Recommendation 5

That if a licensee proposes to use a DOFI to provide PI, that such PI should be approved by ASIC. FICS recommends that applications should be made to ASIC, which could perhaps be assisted by APRA, to assess whether PI provided by a DOFI is an approvable 'alternative arrangement' to 'adequate PI'. Normally, 'adequate PI' would be provided by an APRA-authorised insurer.

2. Part 2 - FICS Response to Proposals and Questions

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
Adequate PI insurance			
B1	We propose that a licensee's PI insurance policy should have a *per claim* limit of at least as high as the maximum monetary limit that applies to their EDR scheme.	B3Q1	FICS supports Proposal B1, although suggests that ASIC's Regulatory Guide provide guidance to licenses that they should consider the exact wording of their policy to check the definition of 'claim'. From a licensee's point of view what is proposed would seem to be inadequate cover because if a licensee has a much larger claim than the EDR Scheme limit which went to Court, then they would need PI that covered the claim. FICS suggests that 'adequate PI' might be better defined to have a per claim limit which exceeds the maximum monetary limit that applies to their EDR scheme, taking into account the risk profile of the individual licensee. In FICS' experience, PI insurers have demonstrated an unwillingness to embrace EDR processes, often providing no or modified cover for EDR decisions. Several insurers have responded to the Westpoint claims by vigorously resisting the jurisdiction of FICS. Any 'adequate PI' must recognise the jurisdiction, processes and awards of compensation by approved EDR schemes such as FICS.
B2	For insurance brokers we propose that	B3Q2	No response.

Table of FICS response to ASIC Consultation Paper questions

Proposal No.	Proposal	Qn No.	FICS response
	maintaining the *aggregate* amount of cover required under the superseded *Insurance (Agents and Brokers) Act 1984* would mean the amount of cover is adequate.	B3Q4	No response.
B3	For other licensees, we propose that: the appropriate measure of a licensee's size is the total gross revenue derived from the licensee's dealings with retail clients; minimum *aggregate* cover should be assessed on a sliding scale as follows: for licensees whose actual or expected revenue from retail services is up to $1 million – minimum $2 million cover; for licensees with revenue greater than $1 million – minimum cover should be two times actual or expected revenue from retail services (up to a capped minimum of $20 million cover).	B3Q3	FICS supports Proposal B3. In FICS' experience this would be adequate to cover usual events. However this level of cover would be inadequate to cover the catastrophic losses seen in such an event as Westpoint. FICS encourages the Government to more closely consider one of the policy options raised in the Regulation Impact Statement to the new compensation and insurance obligations: a centralized fund to supplement PI (FICS Recommendation 1).

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
B4	We propose that the Policy Objective and the legislation (as summarised in Appendix 1) require the following as key features of an adequate PI insurance policy: it must cover loss or damage suffered by retail clients because of breaches of obligations under Chapter 7 of the Corporations Act; it must cover breaches by both the licensee and its representatives; it must be available to cover compensation awards made by the EDR to which the licensee belongs; as far as possible, it must continue to provide cover to a period of time after the licnesee ceases business (e.g. run-off cover).	B4Q1	(a) FICS supports proposal B4(a) (b) FICS supports proposal B4(b) (c) FICS supports proposal B4(c) (d) FICS supports the intent of proposal B4(d). FICS suggests that the qualifying term 'as far as possible' be removed. FICS is aware of the practical difficulties that some licensees face in obtaining run-off cover. However, FICS believes that run-off cover is an essential component of an 'adequate' PI policy. If a licensee can only obtain PI cover which does not include run-off cover and is therefore not 'adequate' PI, then that licensee should apply to ASIC for approval of 'alternative arrangements'. Such an application should include evidence of sufficient cash-flow to cover the risks associated with now-retired representatives of the licensee.
PI insurance that is not fully adequate			

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
C1	Where licensees have PI insurance cover that is not fully adequate, we propose that any shortfall be made up by a licensee using its own financial resources. We propose licensees take thee following steps to calculate what is needed and ensure the resources are available for this purpose: Step 1 – the PI insurance gap Step 2 – anticipated excess payments Step 3 – projected cash flows Step 4 – audit report	C1Q1	FICS does not support the Proposal C1 that licensees alone determine whether they have a satisfactory combination of (a) partially adequate PI and (b) sufficient financial resources to make up the shortfall. FICS recommends that a licensee that cannot obtain 'adequate' PI should apply to ASIC for approval of their 'alternative' compensation arrangements (FICS Recommendation 3). Such an application could demonstrate to ASIC set out the grounds of the application by reference to Steps 1-4.
		C1Q2	No response
		C1Q3	No response
Alternative arrangements			
D1	We propose to assess applications for alternative arrangements against the same criteria as apply to PI insurance	D1Q1	FICS supports Proposal D1.

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
	arrangements to ensure that licensees and their clients have comparable protection where alternative arrangements are used in lieu of PI insurance. We propose to approve alternative arrangements *only* where they provide no less protection that adequate PI cover.	D1Q2	FICS supports the proposal for applications for approval of alternative arrangements to be accompanied by the external expert report of an auditor or actuary, as applicable.
D2	We propose to assess applications for alternative arrangements on a case-by-case basis. For the purpose of illustrating how this concept might work, we have proposed below some hypothetical examples of what might possibly be considered alternative arrangements to PI insurance. However, by inclusion in this list, ASIC makes no statement as to whether arrangements of this kind would constitute 'adequate' compensation arrangements or would be approved by ASIC in any particular circumstances or for given licensees.		FICS supports Proposal D2 to assess applications for alternative arrangements on a case-by-case basis.
D3	We propose that the following hypothetical examples illustrate what might or might not be alternative	D3Q1	FICS supports Proposal D3(a). FICS supports the intent of Proposal D3(b). All PI available on the current market leaves gaps. These gaps include fidelity (for example, circumstances in which a

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
	arrangements: Self insurance approach Industry member fund		retail client suffers a loss due to fraud by the principal) and the problem that even where there is PI, it will not cover all losses. Catastrophic losses like Westpoint render a licensee insolvent, leaving retail cleitns with no-one to seek compensation from. FICS submits that there is a sufficient level of risk to warrant the introduction of a centralized fund. Although individual industries might as Proposal D3 suggests each set up a fund, it is preferable that such a fund be Government-supported, both to provide legislative support for levies placed on industry, and to provide some funding for start-up and operating costs.
	Issues in implementing the PI insurance requirements		
E1	Licensees should obtain run-off cover for as long a period as is commercially available.	E1Q1	FICS supports Proposal E1. FICS submits that run-off cover is a feature of 'adequate' PI and that compensation arrangements that do not include run-off should be approved by ASIC. FICS recommends that the definition of 'adequate PI' be amended so that licensees are required to obtain run-off cover, unless alternative arrangements are approved by ASIC (FICS Recommendation 2).
Assessing and obtaining PI insurance			

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
F1	Generally, the cover needs to be from an insurer regulated by APRA under the Insurance Act 1973.	F1Q1	FICS supports Proposal F1. FICS submits that 'adequate PI' should be defined as PI that is provided by insurers that are authorised by APRA. This means that 'cover' provided through membership of a discretionary mutual fund (DMF) would not be 'adequate'.
		F1Q2	In the FICS experience an assessment of individual policy conditions and exclusions might not be adequate unless they are considered on the basis on how they interact with each other. For example, in one policy there was a limit of $100,000 per claim, for claims considered through the EDR Scheme, as well as those limited to two claims per year. However, another part of the policy provided for an excess of $100,000 per claim against the licensee and $18,000 per representative. As a claim at FICS is always a complaint against the licensee it would appear that the policy gave no cover for claims at FICS based on the Member paying $100,000 excess for a maximum award of $100,000. Although this policy was never tested in a Court, it highlights the need for a licensee to look at how different aspects of the policy interact with each other thereby affecting cover.
		F1Q3	No response.
F2 F2Q1	We propose that to avoid any client confusion, licensees and their representatives might also wish to explain in their FSG (as relevant) that:	F2Q1	FICS supports Proposal F2. FICS recommends that licensees should be required to disclose the matters set out in the Consultation Paper and that they should be required to do so in plain English that does not unreasonably extend the length of FSGs (FICS Recommendation 4).

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
	the insurance is there to meet claims where the liceensee or its representatives are found to be liable (e.g. by an EDR scheme or court) during the period of the policy; the consumer is not directly covered and has no right to bring an action under the policy; the policy will not necessarily be adequate to meet all possible claims against the licensee (e.g. if an extraordinary level of losses occurred for a licensee, the losses might exceed the agreed level of cover under the policy); PI insurance is designed to help an entity that is a going concern to remain in business, and might be available to meet the claims of other creditors; the policy operates on a 'claims made' basis and will only respond if a claim is made during the policy is on foot [sic];		

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
	certain exclusions apply.		
F3	We propose to administer the obligation to have adequate PI insurance by requiring licensees who fall within these groups to have at least the cover that is required under our existing policies. Therefore, these existing requirements will continue to apply to these licensees.	F3Q1	No response.
		F3Q2	No response.
F4	We propose to ask applicants for a licence that is expected to commence on or after 1 January 2008 questions about: the insurer and the type and level of PI insurance cover they have in place; the scope of cover and whether the policy covers claims relating to all the products that the licensee wishes to provide under the licence; and whether the policy contains certain important features (e.g. the features discussed in this Section [F]).	F4Q1	FICS supports Proposal F4.

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
Exemptions			
G1	We propose to approve guarantee *only* where they provide no less protection than adequate PI insurance cover (reg 7.6.02AAA(3)(b)(ii)(B)).	G1Q1	No response.
		G1Q2	No response.
Appendix 2			
	PI insurance cover – additional guidance for small licensees		FICS supports the proposal to provide (a) additional and (b) specific guidance to small licensees with an annual turnover of less than $2million. Excess – It should be noted that an excess of 5% of annual average revenue is quite high and could have a crippling effect on a licensee if applied to each of a related set of multiple claims. Scope of cover – Although the regulations require that PI cover all breaches of the obligations of licensees and their representatives under Chapter 7 of the Corporations Act, this wording is not generally found in PI policies. To assist small licensees, it may be useful for ASIC to itemise the key obligations of the licensee and their representative under Chapter 7 of the Corporations Act, so that small licensees could use this as a checklist to ensure that their policy is 'adequate'. FICS' experience of the Westpoint collapse is that the number and amount of claims for compensation against a licensee will not always be proportionate to their

Table of FICS response to ASIC Consultation Paper questions			
Proposal No.	Proposal	Qn No.	FICS response
			size or solvency. Licensees whose compliance regimes are least likely to reduce the risk of breaches of their obligations under Chapter 7 of the Corporations Act are also as a general rule, the least likely to have 'adequate' compensation arrangements. There is therefore a risk that the clients most likely to need to claim under PI would be least likely to find 'adequate' PI standing behind their licensee.

Conclusion

FICS appreciates the opportunity to provide feedback to ASIC on its proposals for administering the new compensation and insurance obligations on licensees set out in the Consultation Paper and anticipates that through this consultation an appropriate balance between consumer protection and the flexible and efficient regulation of licensees can be achieved.