

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.