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Dear EDR Team,

AFA Submission – Improving Dispute Resolution in the Financial System

The Association of Financial Advisers Limited (**AFA**) has served the financial advice industry for 70years. Our objective is to achieve *Great Advice for More Australians* and we do this through:

- advocating for appropriate policy settings for financial advice
- enforcing a Code of Ethical Conduct
- investing in consumer-based research
- developing professional development pathways for financial advisers
- connecting key stakeholders within the financial advice community
- educating consumers around the importance of financial advice

The Board of the AFA is elected by the Membership and all Directors are required to be practicing financial advisers. This ensures that the policy positions taken by the AFA are framed with practical, workable outcomes in mind, but are also aligned to achieving our vision of having the quality of relationships shared between advisers and their clients understood and valued throughout society. This will play a vital role in helping Australians reach their potential through building, managing and protecting wealth.

Introduction

The AFA supports improving dispute resolution in the financial services system. While the outcomes and experiences of AFA Members show that the financial system's dispute resolution framework is largely working effectively, efficiently and at a lower cost than through the courts, the AFA acknowledges that these areas are areas where improvement is required.

At the outset, we believe that it is important to emphasise that customers have a choice between utilising the External Dispute Resolution (EDR) scheme or the Courts. An EDR scheme provides significant benefits for consumers as it provides a cost free and timely avenue to assess complaints. In addition, the determination of the complaint is binding on the financial services provider, yet the consumer can choose to take the matter to court if they are not happy with the EDR outcome. Thus, there are significant benefits in an EDR scheme for consumers. The cost-free nature and the binding nature of the determinations have a significant impact upon financial service providers. The cost-free nature of the EDR scheme removes the most significant impediment that would otherwise prevent customers from raising frivolous complaints, whilst the inability to appeal a decision has a direct impact upon the cost of professional indemnity insurance.

It is essential the there is a clear policy position on whether an EDR scheme should be a cost effective scheme to deal with lower cost disputes or whether it should entirely replace the avenue of taking a complaint to court. The key point that we seek to emphasise is that given the non-appealable nature of EDR determinations there is a very real impact upon professional indemnity insurance which has a flow on impact on the availability and cost of financial advice. This is necessarily a balancing act that needs to take the benefits of all parties into account.

Accordingly, the AFA supports the Government's commitment to improving dispute resolution in the financial services system and a 'super-ombudsman' could be the solution – provided that the scheme is well thought out, addresses the underlying issues and is implemented carefully to manage the consequences that will flow from transitioning the existing system to a new one. The AFA considers that Treasury's proposed framework has the capacity to improve the outcome for consumers and we have provided practical recommendations for how to improve the outcomes for all participants of the system.

Whilst we see the merits of a one-stop shop, we also recognise the potential risks of such an outcome. In particular, the AFA appreciates that there is some level of competition in the market place at the moment that enables financial service providers to choose their EDR scheme. Such competitive tension ensures that there is an incentive to remain efficient and cost effective. Without competition, it is possible that the focus upon operational excellence will disappear and there will be no incentive to deliver cost effective dispute resolution services. Such an outcome would be disadvantageous for all parties. We believe that measures need to be added to ensure that the dispute resolution service remains efficient and effective.

We note that the legislation provides very general powers to ASIC in terms of requirements of the AFCA scheme and reporting by licensees. It is our view that these powers should be more clearly defined or as a minimum subject to consultation provisions.

The costs of providing advice in future will increase because of this new system. This comes at a time of other increased costs for the profession. In aggregate, these expected cost increases have the potential to reduce some consumers' access to quality financial advice and could lead to some smaller licensees exiting the market due to increased professional indemnity costs. The AFA believes that great advice for more Australians leads to significant community benefits however the increasing costs of running an advice licensee and advice practices could lead to consumers having less choice when selecting an advice professional, and also making financial advice less affordable. It is essential that overall regulatory reform regime does not lead to a reduction in the availability or affordability of financial advice.

Further, clarity is needed around the reporting proposals to reduce the potential for adverse consequences. The draft legislation suggests that AFCA would need to report every single breach of the law to ASIC. This might be relatively small disclosure matters or more significant advice quality matters. A reporting regime without any filter will have a huge cost impact upon both AFCA and ASIC. It is strongly recommended that there is some materiality measure applied in this context. It might be that it is positioned somewhere between the current EDR systemic issue provision and the licensee significant breach requirement. Finally, the transition to the new model involves significant risks and will need to be carefully managed to avoid a loss of capability and a consequential decline in consumer outcomes. The AFA considers that all of these contingent elements are integral to developing an effective and fair system to resolve future disputes in the financial services sector.

Summary of the AFA's recommendations

The proposed framework

1. Re-evaluate how the new scheme will be established and resourced.
2. Transition period of duplicated systems to be managed carefully to maintain service standards.
3. Greater clarity on when AFCA's requirement to report breaches to ASIC arises.
4. IDR reporting measures need clarity on the details to be reported.
5. Strengthen the accountability of the new scheme.

Jurisdictional issues

6. An independent process be established to set jurisdictional monetary caps and limits.
7. The Government (preferably via the Australian Law Reform Commission) to review the practice of splitting claims through EDR schemes.

Improving fairness and transparency in EDR

8. Establish a determination review system with limited grounds for review.
9. Introduce a summary decision process, especially for fee disputes.
10. Create guidance for decision makers on how a 'fair in all the circumstances' resolution should be applied.
11. Create guidance on how proportionate liability should be applied and when other firms should be joined to a dispute.

Consequences to be mindful of

12. Future accessibility of financial advice.
13. Assessing the competitive impact of increased costs on access and affordability of financial advice.

The AFA's recommendations for improvement

The proposed framework

Recommendation 1

Re-evaluate how the new scheme will be established and resourced

The draft legislation requires the new external dispute resolution (**EDR**) scheme[1] to be a company limited by the guarantee of its members governed by a board of directors with an independent chair and an equal number of consumer and industry representatives. The AFA considers at least one of the industry directors should be an experienced financial adviser. All financial firms who are required by law or licence condition to be a member of an EDR scheme, must be a member of this scheme. This is the corporate model that the Financial Ombudsman Service (**FOS**) and the Credit and Investments Ombudsman (**CIO**) operate under.

The Fact Sheet and Consultation Paper provided by Treasury indicates that these two existing schemes and the Superannuation Complaints Tribunal (**SCT**) will continue to operate after the authorisation of the new scheme to work through their existing disputes. The SCT's 'run off' timeframe is predicted to be about two years based on the current backlog of disputes. This appears to indicate that AFCA needs to be established as a fourth EDR scheme operating for a transitional period of about two years alongside FOS, CIO and the SCT.

The requirements for authorisation and the sustainability of the whole EDR process suggest that the only probably candidates for the AFCA role are the existing EDR schemes. It is noted that neither the legislation nor the explanatory memorandum gives any consideration to the possibility that one of the existing schemes might end out taking on the role of AFCA. Holding onto the existing capability and retaining the effective operation of the existing schemes is particularly important, not just for the transition period, but also on an ongoing basis. The AFA believes that the only parties with the required capability are the two existing schemes and that the legislation should address this possibility and ensure that such a transition could be done in both a practical and streamlined manner.

Should one of the existing schemes succeed in being selected to perform the role of AFCA then it would be necessary to consider how they would develop the new terms of reference, sign members to the new arrangement, but also continue to provide services to existing complainants under the existing scheme.

Accordingly, the legislation should provide the means by which one of these two existing schemes could be enabled to take over the operations of the other scheme and establish a monopoly over dispute resolution in financial services. We believe that there should be greater clarity on how this would work in practice. We also believe that the legislation needs to put in place measures to ensure that AFCA remains competitively effective and efficient despite the existence of a monopoly regime.

[1] "New EDR scheme" is the term used in the Explanatory Memorandum.

Recommendation 2

Transition period of duplicated systems to be managed carefully to maintain service standards

Should a fourth EDR scheme be established, this scheme will need to be staffed with "appropriate expertise"[2] to operate an EDR scheme. As the scheme will have authority to deal with all types of financial services disputes, it would be essential that mechanisms were in place to ensure that it had access to the dispute resolution expertise and management experience in financial services that is currently employed by FOS, CIO or the SCT. It is not entirely clear how the new entity will be set up and the existing entities continue to operate, all within the constraints of the existing industry human and other resources. Unless the transfer of expertise from these three existing organisations to AFCA is managed very carefully, there is a substantial risk that service levels over the transition period at the existing three schemes will diminish as the case worker expertise flows over to – and senior and middle managers compete for management positions at – AFCA.

Whilst some disruption is inevitable under the Government's proposal, the three existing schemes have obligations to their memberships (and consumers are entitled to expect) that the schemes will maintain service standards during the transition period. A relevant issue to consider is how to ensure that the staff in the three existing schemes will have sufficient incentive to move over to AFCA or remain where they are needed. The staff of the SCT are government employees while the staff at FOS and CIO are private company employees. These staff have accumulated entitlements that they will be keen to see protected or recognised under the AFCA system. Without consideration of how those entitlements are protected or recognised, there is likely to be leakage of expertise that the Government and that the existing schemes may have difficulty responding effectively to.

Whilst the AFA appreciates this is breaking new ground to merge the operations of the three existing schemes (two of whom are currently ASIC-approved and one is a statutory scheme) into one Minister-approved 'super-ombudsman', the current proposal appears to be fraught with issues and potential unintended consequences. The way AFCA is established and then resourced needs to be re-evaluated and the execution of the transition of expertise – and managers – needs to be thought out with a view to maintaining service standards at the existing three schemes while AFCA is established.

Recommendation 3

Greater clarity on when AFCA's requirement to report breaches to ASIC arises

The draft legislation provides for AFCA to be required to report to ASIC:

- contraventions of any law or of the governing rules of any regulated super fund or approved deposit institution,
- breaches of the terms or conditions of any annuity policy, life insurance policy or retirement savings account,
- systemic issues relating to members' complaints management functions, and
- refusals or failures, by any parties to complaints, to give effect to determinations.

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[2] Section 1047(e) requires the scheme "to ensure that appropriate expertise is available to deal with complaints".

This is a substantial expansion of the current reporting requirements of the existing three EDR schemes, whereby FOS and CIO are currently required to only report to ASIC identified systemic issues. The AFA appreciates that this provision is intended to overcome a current difficulty with ASIC obtaining information about specific disputes because the confidentiality requirements of FOS's and CIO's terms of reference do not permit those schemes being able to breach privacy willingly. Accordingly, the current process requires ASIC to serve FOS or CIO with a compulsory disclosure notice under section 33 of the *Australian Securities and Investments Commission Act 2001* in order to collect information about particular licensees or disputes.

The AFA supports ASIC being able to better obtain information about breaches of the law from EDR schemes because the more information available about misconduct the greater will be the effectiveness of the regulator. However, there would appear to be a need for a sensible materiality provision to apply in the reporting regime and for greater clarity about when the obligation to report to ASIC arises, whether the requirement is to report suspected or determined breaches and what level of detail is provided to ASIC. Given the implications of reporting a licensee or specific adviser to ASIC AFCA will necessarily need to take this obligation very seriously and it is therefore expected that a reporting regime that lacked a materiality filter would add significant workload and resourcing requirement to both AFCA and ASIC. The AFA believes that this needs to be sensibly addressed.

The AFA is concerned that the reporting obligation could be abused by case workers at AFCA as a means by which to influence financial firms (or their representatives, such as their financial advisers) to resolve a dispute in order to avoid a determination on the issues. The AFA has received feedback that case workers at FOS already influence licensees to reach "commercial settlements on a without prejudice basis" by asking the licensee (or their representative) to consider the cost of a determination should the licensee continue to dispute the consumer's allegations. This practice is rationally more influential for lower claim value disputes where the cost of FOS fees outweighs the value of the claim.

This practice appears to have increased since FOS implemented the new 90-day timeframes to deal with disputes and new case management procedures requiring case management conferences to be employed.

The Oxford Dictionary defines fairness as:

> *impartial and just treatment or behaviour without favouritism or discrimination*

This imports a sense that the structure of AFCA, it's terms of reference and the means by which the case workers assist the parties to resolve disputes must not allow for parts of the process to favour consumers or financial firms. There must be balance in the treatment of the disputing parties and just because the financial firm may have the financial capacity to "offer" a commercial settlement does not justify the firm being unduly influenced to do so.

Another aspect of the reporting obligation is whether the obligation will be to report suspected, actual or perceived breaches/contraventions. EDR scheme determination timeframes are necessarily short. This impacts on the level of information available to be considered and decided upon with EDR schemes. An EDR scheme need only be satisfied that a breach is likely to have occurred in order to award compensation. If all determinations in a consumers' favour were to be reported to ASIC without applying a further filter or threshold to assess those cases against this, risks increasing the regulatory costs for all licensees in the system.

The further issue with this is that court decisions are appealable and whether a breach of the law has actually taken place is often the subject matter of 'question of law' appeals. While EDR scheme decisions are technically appealable as well, if the obligation to report a breach/contravention arises upon an EDR scheme's "finding" of a breach/contravention and before a more rigorous examination of the evidence has taken place, there is a question whether this process prejudices the financial firm by subjecting them to regulatory enforcement procedures while they may dispute the EDR scheme "finding".

FOS and CIO understand this dilemma because their current systemic issues procedures do not report to ASIC until they have given the licensee adequate time to respond to the possible systemic issue. The existing EDR schemes understand the potential impact that a systemic issue report can have on a financial firm when it may not actually be a systemic issue.

Accordingly, the AFA recommends that Treasury introduces a materiality measure and provides greater clarity on when the reporting obligation will arise, whether the obligation will be to report actual, suspected or "found" breaches/contraventions and what level of detail is provided to ASIC.

Recommendation 4

IDR reporting measures need clarity on the details to be reported

The AFA supports ASIC being provided with de-identified data about complaints dealt with by licensees' internal dispute resolution (**IDR**) processes because this information can assist ASIC's monitoring of trends within the regulated population and serve as a cost-effective front-line source of information. However, the draft legislation does not state what information is required to be reported, what level of identifying information is to be reported and when the obligation to report arises. Instead, the draft legislation says:

> *ASIC may, by legislative instrument, specify information that financial services licensees must give ASIC relating to their internal dispute resolution procedures and the operation of their internal dispute resolution procedures.*

The AFA understands that the use of a legislative instrument by which the detail will be communicated to the regulated population may be a more flexible method of outlining the information. However, there is no obligation upon ASIC to consult on those legislative instruments – and whom ASIC must consult with.

The AFA recommends that to provide for certainty, the IDR reporting measures need clarity on the details to be reported.

Recommendation 5

Strengthen the accountability of the scheme

The proposed scheme will create a monopoly over alternative dispute resolution in financial services. As all financial firms who must be a member of the scheme, as a result of a legal obligation or licence condition, will have no other choice but to be a member, and then to comply with the scheme's decisions that are arrived at without the same rigour of court processes and also cannot be reviewed for error under the current system, this creates substantial concern for many financial firms, financial services professionals and their insurers. Rightly or wrongly, the perception is that

this is a system that has the potential to be abused without the right accountability measures in place.

Whilst the governance of the new scheme is required to be balanced by equal representatives with consumer and industry experience, the boards of the existing dispute resolution schemes do not involve themselves in everyday dispute cases. They are required to look at things from afar, to examine trends, ensure the scheme can operate financially and oversee the interactions with other stakeholders. Should a bias develop – consumer or industry – within the case workers, this will not be immediately apparent to the board of the new scheme. Given the reporting delay between front line and board levels, should resolution timeframes become inefficient or outcomes become ineffective due to compliance issues, this again will not be immediately apparent to the board.

Likewise, although ASIC will have oversight over the new scheme and be able to direct the scheme to correct issues with its operations, the reporting delay will not ensure that ASIC can be responsive to the needs of the users of the scheme.

The risk is that without a competition signal for the monopoly, the scheme's accountability measures will not be sufficiently nimble enough to deal with issues that arise and accumulate. There needs to be better accountability measures in place to ensure the scheme complies with the eight approval requirements under the legislation.

The AFA recommends that to strengthen the accountability measures, without changing the monopoly "one stop shop" status of the scheme:

- establish an independent process to review jurisdictional limits and compensation caps (as outlined in Recommendation 6, below);
- establish a determination review system with limited grounds for review (as outlined in Recommendation 8, below);
- within the legislation, require comprehensive independent reviews be conducted over the whole scheme operations every three years, but mini-independent reviews be conducted annually into the important measures of expertise, timeliness and fairness;
- stakeholder panels to be set up to report directly to the board on a quarterly basis, with there being separate panels for each interest to convey any concerns about trends or particular disputes and appointment to these panels be vested with the various representative bodies in the sectors (for example, a consumer representatives panel, a banking and finance industry panel, life and general insurance panel, financial advice firm panel, superannuation trustee panel, product manufacturer panel, etc.);
- ASIC to consult with industry and consumer groups prior to directing the scheme to change its terms of reference and prior to approving any changes proposed by the scheme; and
- clear guidelines and protocols be established – with input from the stakeholder panels – to ensure that:
    - sufficient staff with industry experience are employed by the new scheme;
    - guide staff and decision makers on how to apply proportionate liability to disputes – even where there is only one firm responding to the dispute (as outlined in Recommendation 11, below); and

- ensure that the 'approaches to dispute issues' developed by the new scheme factor in best industry practices and up to date legal precedents.

The AFA considers that these are measures that can be implemented easily and work in other jurisdictions and systems to increase accountability. As the scheme will have a monopoly over alternative dispute resolution in financial services, it is imperative that the scheme's management and staff are accountable and responsive to developing issues. Whilst it remains important that the regulator has ultimate oversight over the scheme, the regulator is not infallible and should not be the sole body to which the scheme is accountable to.

Jurisdictional issues

Recommendation 6

An independent process be established to set jurisdictional monetary caps and limits

The AFA recommends that an independent process be established to set and review EDR scheme jurisdictional limits and compensation caps. To do otherwise is to simply guess at where to draw the line by which consumers are excluded from EDR redress and which also serves to define financial firm liability through their professional indemnity arrangements. That process should also be tasked with the role of examining the reviewability of EDR decisions and fair attribution of liability and the application of proportionate liability.

Jurisdictional limits and compensation caps are currently set by each EDR scheme themselves. Whilst this may be done with ASIC's approval of the respective Terms of Reference, there appears to have been little research into – and therefore justification – for the current amounts. Additionally, the AFA has received feedback from several sources contending that the current limits and caps are too high given that there is no current avenue for appeal of a determination against a licensee.

The proposals to increase the current EDR monetary limits and caps have the capacity to significantly increase a licensee's exposure which has implications for future professional indemnity terms for the licensee and for the terms that will apply to licensee representatives as well. The AFA notes that the Expert Panel in its Final Report to the Government in April 2017 said[3] that:

> *monetary limits and compensation caps applying to other complaints ($500,000 and $309,000 respectively) have fallen behind what is required to ensure access to redress for consumers, with the value of many financial products and services being higher than the current limits*

The AFA disagrees with this means of measuring the appropriateness of jurisdictional limits and compensation caps because it presumes that all complaints about financial products are for the full capital invested and should be considered by an EDR scheme.

It also fails to take into account factors such as the average superannuation balance, which would suggest that the existing caps are more than adequate.

Importantly, this statement does not appear to appreciate that alternative dispute resolution has never been intended to capture every single dispute that arises in a sector. It is a system to be *an*

[3] The Treasury, Commonwealth of Australia, *Review of the financial system external dispute resolution and complaints framework* (Final Report), 3 April 2017, page 9.

alternative, not the supplement, to the courts. Not every dispute about financial services is appropriately dealt with by an EDR scheme. The purpose of alternative dispute resolution is largely to provide an accessible means by which consumers can complain about the conduct of firms.

Another aspect to consider with jurisdictional limits is that Regulatory Guide 126 requires AFS licensee to have at least $2 million of professional indemnity insurance coverage (excl. legal fees). If the non-superannuation complaint jurisdictional limit of AFCA is raised to $1 million, the question arises whether the compensatory requirements of AFS licensees will remain adequate at the current level.

In conjunction with this, the AFA considers that the independent process should be informed not just by three experts who receive public submissions. The process should be research-based and able to point to empirical data that is available. It should be able to consider all types of financial services and financial products and take an actuarial approach to the methodology, rather than a populist one.

There should be <u>particular</u> reference and input from professional indemnity insurers and their actuaries to ensure awards will be able to be met at all times by the market into the future.

It is also noted that increasing the caps has a disproportionate impact on smaller licensees as the larger groups might either be self-insured or have greater access to cost effective professional indemnity insurance.

Recommendation 7

The Government (presumably via the Australian Law Reform Commission) to review the practice of splitting claims at EDR

The AFA appreciates that the practice of 'splitting claims' has a foundation in law. Through the courts, claim amounts are tethered to each cause of action and set of facts. The new EDR scheme's terms of reference is a good vehicle for reviewing the practice of splitting claims. The AFA considers that the new EDR scheme's terms of reference should create clear rules about how complaints with multiple claims are dealt with fairly through the EDR scheme's jurisdiction.

The ALRC is an ideal forum to examine this issue. It has the ability to consider the legal frameworks, decided court cases, professional journals and publication material as well as take submissions from professional indemnity insurers, consumer advocates, professional associations and other interested parties. The ALRC can also consider international methods of all dispute resolution systems to determine the relative benefits and costs of an alternative dispute resolution process.

Improving fairness and transparency in EDR

The AFA's network of financial advisers and licensees consider that the fairness of the dispute resolution system needs improvement. There have been particular instances of apparent unfairness or lack of procedural fairness that indicate that some latent unfairness exists in the system. The new scheme needs to take into account the issues and concerns of all parties.

As a new professional standards regime is introduced over the coming years, transparency will also become a greater issue as consideration will need to be given to information sharing with

professional bodies once a new code of ethics is implemented and monitoring bodies are appointed to ensure that investigations into financial advisers are not unnecessarily duplicated.

Recommendation 8

Establishing a determination review system with limited grounds for review.

The outcome of the recent case of *Goldie Marketing v FOS*[4] further reinforces that in some exceptional or limited cases there needs to be a low-cost process for disputing parties to seek administrative reviews of EDR scheme decisions. It is a particular unfairness in the system that compels financial firms to be a member of an external dispute resolution (EDR) scheme and then makes it mandatory for those same firms to comply with each and every single determination of the EDR scheme without the ability to have the fairness or procedures that arrived at those decisions subject to independent review.

The AFA is not suggesting that every EDR determination should be subject to an appellate process that allows for the merits of every case to be re-examined. This would only lead to a litigious environment that ultimately increases costs for all stakeholders. Instead, the AFA proposes that an independent mechanism be provided to conduct limited reviews of EDR scheme decisions.

The AFA does not propose for the merits of each of these EDR scheme decisions to be reviewed or for the court decisions to be analysed to ensure the inadequacies are addressed. Instead, we suggest that no system will be perfect and the volume of cases of judicial review of EDR decisions lends weight to a lower cost avenue for review to be provided within the EDR system to examine whether procedural fairness was applied.

EDR schemes should have a review system to support them with the power to do the same as appellate courts to ensure that binding Determinations are fairly and transparently made. This may involve some disputes being referred back for merits review as appellate courts do. We envisage this review process would not be burdened by the adversarial rules on evidence but a simpler set of guidelines for reviewing EDR scheme decisions built around fairness and transparency.

Further, before ASIC has the ability to direct AFCA to change its Terms of Reference, the AFA considers that ASIC must consult on the proposed changes. This is a necessary limit on ASIC's power to unilaterally control aspects of the dispute resolution framework that can have a material effect upon consumers and financial firms alike. If ASIC was not required to consult on proposed changes to AFCA's Terms of Reference – such as increasing monetary limits – there would be a substantial risk that ASIC-directed changes would have unintended consequences for consumers of financial services – such as reduced competition in the financial advice market. The AFA further suggests that the legislation should place some limits on the powers of ASIC to make directions in this space.

Recommendation 9

Introduce a summary decision process, especially for fee disputes

Introducing a summary decision process for fee disputes that costs licensees less than the current systems do, in order to discourage abuses of process, particularly for fee disputes less than $10,000. It is a key peculiarity of the financial services system that permits consumers of

[4] *Goldie Marketing Pty Ltd v Financial Ombudsman Service Ltd* [2015] VSC 292.

professional financial services to make misrepresentation or non-disclosure claims about fees without needing some substantiation for their claims before the respondent to the dispute is liable to pay something. Other professional dispute resolution schemes and processes do not allow for fees to be disputed to the same level or cost to the professional unfairly.

The current process involves a cost to the licensee of at least $3,800 (FOS cost) before an independent merits assessment of the fee disclosure claims will take place. In our Members' view, this is an unfair system that allows clients to make an unsubstantiated allegation of misrepresentation or non-disclosure of the fees. This is despite the evidence presented to them in the IDR response to their initial complaint.

Whilst AFA Members appreciate that consumers of financial services should have the right to raise substantiated claims of misrepresented or undisclosed fees with a free dispute resolution service, the current fee structure often leads to unwelcome encouragement of licensees to resolve disputes on a commercial basis and despite evidence to the contrary simply because of the cost of a merits review.

The AFA considers that a fair manner to deal with misrepresentation and non-disclosure claims about fees would be to first lower the EDR scheme fee for dealing with fee disputes.

The second part of this proposal is to direct these fee disputes to a summary decision process that evaluates the information that both parties present in IDR. If the scheme case worker considers that there is no substance to the consumer's allegations given the evidence provided by the licensee or professional, they should have the ability to summarily dismiss the complaint as lacking in substance. Where there is contradictory evidence to potentially support a claim for misrepresentation or non-disclosure, the case worker would give a view, try to negotiate an outcome and if unsuccessful due to the positions of the parties, permit the dispute to continue to a final Adjudication. The former would end the matter at a low cost to the licensee, while the latter's higher Adjudication cost would still serve to encourage a consensus outcome.

We envisage that this change could be accommodated within both the Fast Track process of FOS (which should be adopted by the new scheme) as well as the Preliminary View process for higher value fee disputes.

It is a necessary part of the EDR system that directs EDR scheme costs toward the licensee on an imbalanced user-pays basis. This, however, influences licensees to make commercial decisions to offer resolutions where the cost to defend against the claims exceeds the value of the claims. Whilst we accept this for investment loss, disputes about insurance claims and disputes about the appropriateness of financial advice, a fee dispute is another matter entirely. In the AFA's view, the system should not make the licensee liable for the merits review cost of at least $3,800 before the substance of the apparent misrepresentation or non-disclosure is even tested. This part of the process needs to change to ensure that the new system is not similarly subject to a lack of balance.

Recommendation 10

Creating guidance for 'fair in all the circumstances' decisions for EDR schemes to adhere to

The AFA considers that principles of fairness require equal consideration of the consequences to be borne by *both parties* if a decision that is adverse to their respective interest may result.

In years past, determinations often did not always state the reasons why an Ombudsman considered it to be 'fair in all the circumstances' that an award of compensation was made. They unfortunately sometimes simply said something along the lines of "I consider it fair in all the

circumstances to award compensation of $X" without showing how that figure was arrived at. Determination reasons have improved with new Ombudsman and Adjudicator appointments but the reliance on a fairness reason to adjudicate a dispute does not always appear to be consistent.

Further, there is an appearance – justifiably or not – amongst some licensees and AFA Members that fairness factors considered in determinations are often only those that relate to what would be fair to the applicant (i.e. the consumer).

In many cases, an award of compensation is considered to be an indicator of misconduct and in turn can lead to higher risk attribution by the licensee's professional indemnity insurer. Further, should a licensee not draw upon it's professional indemnity insurer to pay compensation, the cost will necessarily be borne by the business' other customers and clients in a modern commercial enterprise. There is also the effect that an award of compensation has upon a financial adviser's professional association membership. Further still, there are adviser contribution terms in representative agreements and excess issues that affect future sustainability of a practice.

These are all matters that affect licensees and professionals and consequently should be considerations in questions of the fairness of a dispute decision – just as much as the financial and non-financial loss implications upon a consumer are considerations. The AFA would like to see fairness principles be consistently applied across the dispute resolution system in future to ensure that both perspectives of fairness are equally considered to arrive at the 'objective point of view'. Just as when a departure from the law takes place, decisions relying upon the fairness of the result should also be justified and clearly explained.

Recommendation 11

Create guidance on how proportionate liability should be applied and when other firms should be joined to a dispute.

One area that EDR schemes have historically had difficulty with is the areas of proportionate liability and contributory negligence. Whilst some determinations have applied the legal precedents of proportionate liability in determining the appropriate amount of compensation to award to a consumer, this appears to have been inconsistent in application. There are cases where it has been held that failure to provide a Statement of Advice (**SoA**) or to include some omitted wording in an SoA has been held to be the sole cause of a consumer's losses despite there being evidence of verbal disclosures or other mitigating circumstances. There are other cases where the defective disclosure by a product provider have been disregarded by FOS case workers in determining the cause of a financial adviser's clients' losses

In many of these cases, the EDR approach has been precipitated by the EDR scheme's lack of jurisdiction over companies that were not a member at the time the dispute was decided.

In cases that arose during the GFC involving misrepresentations by product research houses to financial advisers about the risk rating or categorisation of an investment (such as Basis Capital, Absolute Capital, Babcock Brown, Allco, etc), the financial advisers' duty to 'Know Your Product' was in effect held to cancel out all duties that the research house had to the end consumer or to the adviser. In those decisions, the underlying approach was taken that if the financial adviser felt the research house had breached an obligation to the adviser in misrepresenting information to the adviser, that the adviser had then passed onto the consumer, then the adviser should take action against the research house after the adviser was held to be wholly responsible for the consumers'

losses. In those cases, this approach raised the adviser duty of care to a fiduciary duty that had the additional characteristic of cancelling out every other person's contribution to the end result.

The inconsistency in how proportionate liability and contributory negligence have historically been applied when there was evidence of other contributors to a consumers' losses is the concern here. This variability has led to uncertainty for the participants of the scheme and likely impacted professional indemnity insurers' assessment of policy holder risks.

With the establishment of a new scheme that will have a wider, more comprehensive jurisdiction there is an opportunity here to ensure that the historical inconsistency does not recur for future disputes. The AFA considers that the new scheme should be required as part of the statutory conditions on authorisation[5], to be required to have satisfactory guidance or rules in place to ensure that proportionate liability and contributory negligence will be consistently applied by scheme decision makers in dispute determinations. That guidance should also be required to satisfactorily guide case workers in their discussions with disputing parties about likely outcomes and inform their decisions about resolving disputes.

Directly related to the joint issues of proportionate liability and contributory negligence is the question of when another party should be joined to a dispute. The draft legislation provides[6] for the new scheme to have the power of joinder over third parties for superannuation complaints and the AFA understands this is necessary because of the nature of some superannuation complaints, particularly where there is a dispute about a death beneficiary nomination. The AFA recommends this power be extended beyond superannuation complaints to ensure that even if a contributing party to a dispute is not a member of the scheme, the scheme should be able to join the party to examine the contribution or involvement of that other party. If private citizens can be joined to superannuation complaints, then it stands they can be joined to other financial services disputes.

To mitigate against this potential scenario and to ensure that AFCA is appropriately empowered to be effective and resolve disputes with fairness, the AFA recommends that the power of joinder in proposed section 1053 be extended to all disputes dealt with by the new scheme. The AFA also recommends that the scheme be required to establish accompanying guidance to case workers to ensure that the scheme is efficient in joining parties to disputes early in each case to avoid delays in resolving matters.

More broadly, the AFA recommends that consideration be given to whether any of the additional powers that apply to superannuation complaints should also apply to non-superannuation complaints.

Consequences to be mindful of

Recommendation 12

Future accessibility of financial advice

The AFA is concerned about the future accessibility of quality financial advice. The costs of providing advice are rising due to reforms that are under way:

- raising professional standards of financial advisers;

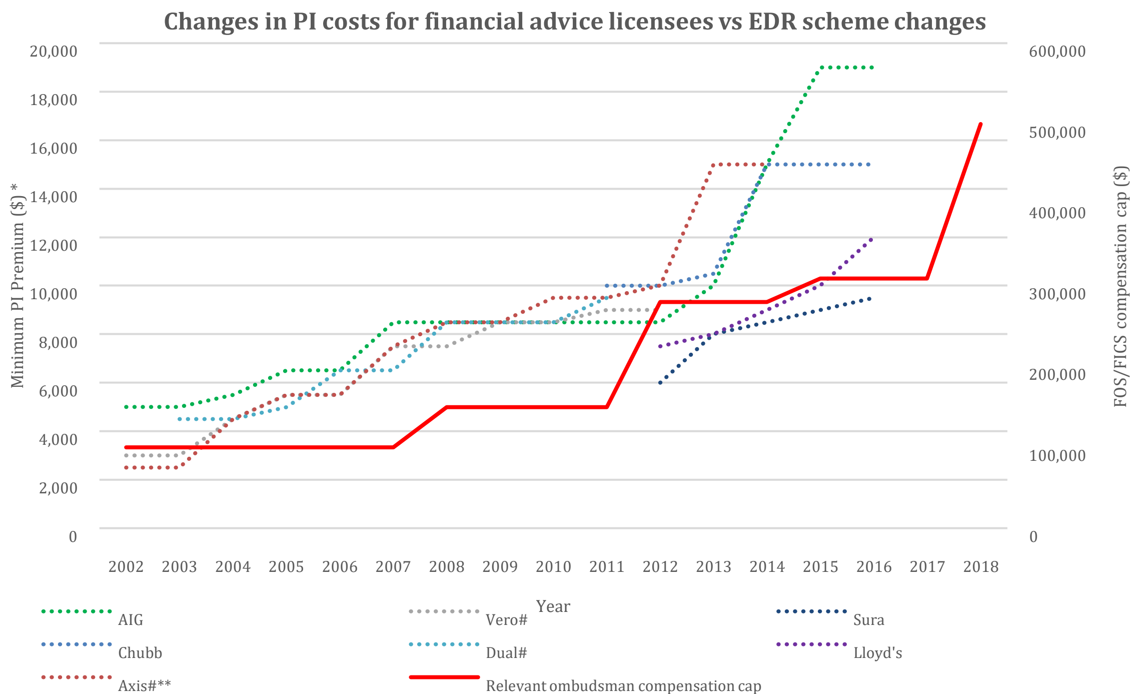
[5] Proposed section 1046 and 1047 of the draft legislation.

[6] Proposed section 1053 of the draft legislation.

- the proposed ASIC Industry Funding model;
- proposed compensation schemes of last resort; and
- higher professional indemnity costs associated with the proposed higher EDR scheme compensation awards and monetary limits.

The AFA supports reform in all of these areas and has been a considered contributor to each consultation. One aspect though of each reform that does not appear to be the subject of coordinated consideration is the impact that regulatory reform will have on the future accessibility of financial advice. Research has shown that access to quality advice has a positive correlation on people's wellbeing, which the AFA considers has a flow on effect to the broader community.[7]

The AFA has called for the regulatory impact of the multitude of reforms underway to be examined thoroughly to understand whether the impact of the reforms is having a material effect on access to financial advice. In particular, the extent to which advice licensees are unable to afford their professional indemnity excess as well as their annual premiums should be examined to determine what impact that has had on their businesses including the accumulation of unpaid determinations. The following is a summary provided by a professional indemnity insurance broker about the historical changes in the minimum professional indemnity premiums for financial advisers over time and as the compensation caps increased:



Premiums are excl GST and stamp duty

* min PI premium are for AFS licensees with a maximum turnover $400,000 in income p.a., coverage consists of $2.5 million in any one claim and $5 million in the aggregate and average excess of $10,000

** known prior to 2005 as Dexta

exited the market (Dual in 2013, Vero in 2014 and Axis in 2016)

[7] Beddoes Institute, *Money, wellbeing and the role of financial advice – AFA White Paper* (May 2016); Beddoes Institute, *The value of protection: Creating an advocate for life – AFA White Paper* (July 2013); Core Data, *Workplace Financial Wellness Index – Workplace Super Specialists of Australia White Paper* (September 2016);

At Appendix 1 of this submission are actual premium changes for five clients of an insurance broker who specialises in professional indemnity insurance for financial advice licensees.

The above analysis and that at Appendix 1 show that there has been an increasing trend over the last 15 years for professional indemnity costs to increase when EDR scheme compensation caps change. This is to be expected due to the nature of insurance covering risk levels. However, this was also at a time that coverage of policy terms became more narrow and focussed. Thus the full extent of the increase in premiums is understated by these charts.

Should monetary limits and compensation caps increase further without the level of risks being informed by independent research to justify their imposition, there is a real risk that financial firms – especially the smaller of them – will seek to exit the market. Further, as the professional indemnity market is a competitive market, there is an additional risk that insurers will exit the space (as they have done in the past) thereby placing further pressure on supply which can have a consequential effect on the price Professional Indeminity insurance and therefore also advice

This issue should not be ignored or categorised as a problem for only the advice profession. As will be outlined elsewehere in this submission, changes to the professional indemnity market or in other factors affecting price have an end result on consumers if the accessiblity or affordability of financial advice is restricted in future or competition in the financial advice market contracts. These are effects that Treasury should have regard to as relevant and considerable concerns given the contingent effects that are likely to result. For more on these effects and how this is relevant to the reform of dispute resolution, see the final two recommendations below.

Other issues with professional indemnity that the AFA consider should also be explored include:

- the differences in professional indemnity insurer interpretations about what falls into the fraud and dishonesty exclusions contained in many professional indemnity policies. We understand this is an area that ASIC has recently looked into and the AFA can provide further information, should Treasury require;
- whether the minimum coverage requirements of ASIC Regulatory Guide 126 cover multiple EDR claims in every case and whether an aggregate limit should apply in cases of multiple claims;
- whether there are ways that non-payment of professional indemnity premiums can be better monitored by ASIC. In particular, data sharing between ASIC and insurers should be explored; and
- whether there are any other causes of professional indemnity policy terms or claim applications that have contributed to unpaid determination.

The AFA wishes to ensure that a holistic approach is taken to the problem of unpaid Determinations. This is mostly to ensure that the effectiveness of the new EDR scheme is maximised.

Accordingly, we recommend – again – for Treasury to engage all areas of the financial advice profession (advisers, licensees, regulators, professional indemnity insurers) to examine what the impact of the current and proposed reforms will have on the future accessibility of financial advice. Yes, we should be reforming the areas that need to be reformed. Our regulator needs a better system of funding; our dispute resolution system needs to be improved; financial advisers' professional standards need to be lifted and standardised and advisers need to be recognised within the community as deserving of their place alongside other professions.

But should the pace or timeline of reform be more measured? Should the contingent costs of reform be understood before choosing a path that could produce an equivalent improvement but at less cost to the next generation? The value of quality financial advice should be a factor in the regulatory impacts of reforms to financial advice and should not be ignored with this reform.

Recommendation 13

Assessing the competitive impact of increased costs on access and affordability of financial advice.

A related issue with rising financial advice costs is the effect that rising costs have upon competition. As we said recently in a joint submission with the FPA on ASIC Industry Funding:

> *The FPA and AFA are very concerned about … the impact [that rising costs] will have on market competition in the financial advice sector…This, at a time when the benefits of competition must be encouraged to help drive improvements in the quality of financial advice for consumers. Market competition is needed to challenge the status quo and drive the cultural change the Government, ASIC and consumers are calling for. Small licensees establish themselves to move away from such cultures and help to drive this cultural change. Counter to the Government's 'cultural change' agenda, the draft Regulations appear to support the institutionalisation of financial advice.*

The AFA considers that the expected increase in professional indemnity costs that will result from raising the monetary limits and compensation cap – without the necessary research to justify those increases and without plugging the problems with professional indemnity – will likewise lead to a greater tendency for consolidation in the market to take place. It's an accepted fact of business that rising operational costs squeeze smaller businesses out of the market if mitigating measures are not implemented. It's also an established concept that market competition has a substantial consumer protection value.

If it becomes too costly to service advice clients in future – in part due to the cost of dispute resolution and the contingent cost of professional indemnity insurance – the larger institutions (who are often self-insured) will have greater capacity to acquire those businesses or to take over smaller competitors.

There is a very good chance in the AFA's view that the proposed improvements to dispute resolution will have an effect on competition through increased costs. If those increased costs through raising monetary limits and compensation caps cannot be substantiated as being appropriate in light of the other aspects detailed in this submission, the AFA recommends that Treasury defer implementing the change to monetary limits and compensation caps until the effects can be better understood and dealt with.

Concluding remarks

Dispute resolution in financial services has been a source of many complaints over the years – from consumer groups, industry and advice professionals. In the AFA's view, this is reflective of the difficult place that dispute resolution resides when consumers are at risk of significant financial loss, loss of assets and loss of protection. Effective dispute resolution is critical to ensuring that there is confidence and trust in the financial services sector, which is a major contributor to the Australian economy. The fact that not any particular group is perfectly happy with the framework indicates that there is some balance in the system and the system has been shown over time to largely function well.

Nevertheless, there are some areas that the AFA considers require improvement to create a fairer and more transparent system. Amongst the most pressing of which are the creation of a review process to ensure that participants within the system do not unnecessarily have to resort to litigious processes to resolve their disputes or to lose confidence in the integrity of the system. Other fairness improvements lie in creating guidance around how and when an EDR scheme can make a 'fair in all the circumstances' decision, how proportionate liability and contingent negligence should be applied and when third parties should be joined to a dispute. The new scheme should also introduce a fairer method of assessing the substance of disputes about fees.

Whilst the proposal for reform has merit and no system will be perfect, there are substantial structural and jurisdictional issues that should be reviewed and/or researched further before moving to the next stage of implementation. How AFCA is to be created within the existing system needs to be better addressed to ensure that the new EDR scheme will not disrupt the ability of the existing schemes to maintain service levels during the transition. The reporting requirements to ASIC require greater clarity and consideration as does the accountability of the scheme to ensure that the disadvantages of a monopoly power do not impact on the fairness or transparency of the system.

Research needs to be undertaken into the practice of splitting claim amounts within the EDR system and the appropriateness of the proposed monetary limits and compensation caps.

Reform needs to be in the interests of the community and rolled out in a measured way to ensure unintended consequences can be mitigated rather than dwelt upon with the benefit of hindsight. If we are to create a robust and effective system of dispute resolution in Australia in the future, these are all aspects of the system that need consideration and the AFA welcomes further consultation with Treasury should it require clarification of anything in this submission. If required, please contact us on 02 9267 4003.

Yours sincerely,

Philip Kewin
Chief Executive Officer
Association of Financial Advisers Ltd

Appendix 1 – Case study comparison of professional indemnity costs for advice licensees

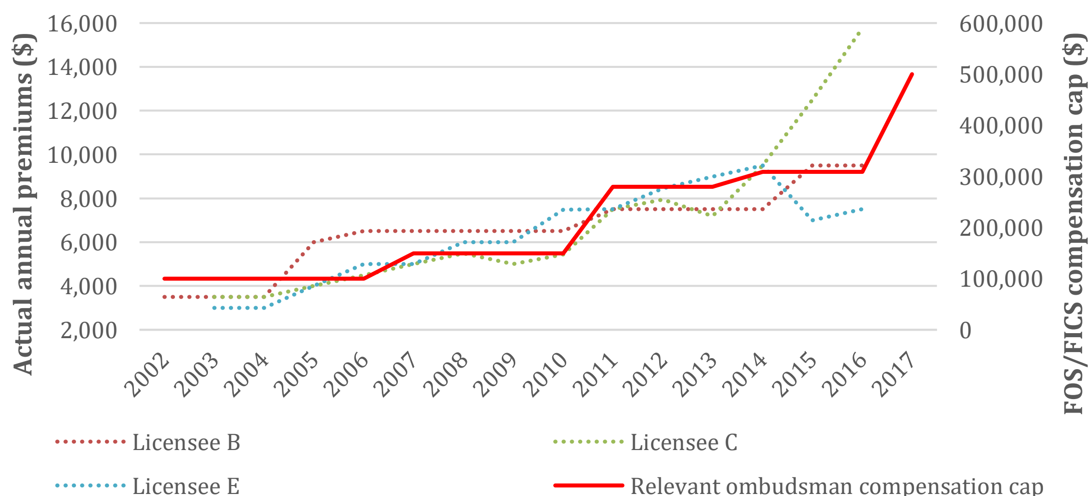
Below is the actual data on professional indemnity insurance premiums paid by five clients of an insurance broker who specialises in professional indemnity insurance for financial advice licensees.

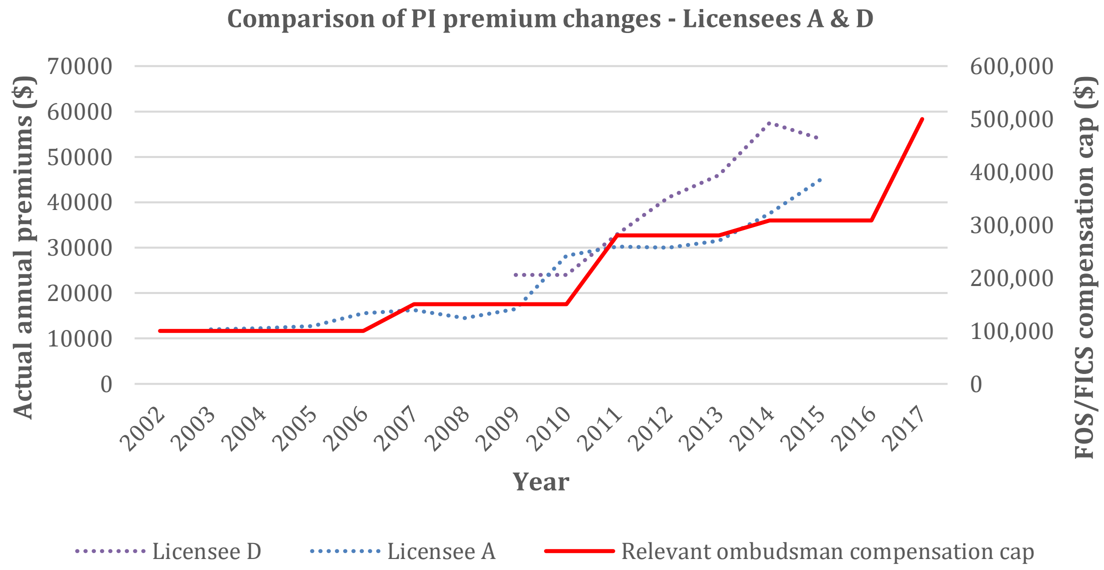
It should be noted that the results below were the result of active broking to find cover at lower prices when premiums increased unexpectedly, such as when EDR scheme compensation caps changed.

	Annual professional indemnity premium				
Financial year	Licensee A	Licensee B	Licensee C	Licensee D	Licensee E
2002/3		$2,500			
2003/4		3,500			
2004/5	$12,000	3,500	$3,500		$3,000
2005/6	12,300	3,500	3,500		3,000
2006/7	12,700	6,000	4,000		4,000
2007/8	15,500	6,500	4,500		5,000
2008/9	16,310	6,500	5,000		5,000
2009/10	14,500	6,500	5,500		6,000
2010/11	16,500	6,500	5,000	$24,000	6,000
2011/12	28,250	6,500	5,450	24,000	7,485
2012/13	30,210	7,500	7,500	33,000	7,500
2013/14	30,000	7,500	7,950	41,000	8,450
2014/15	31,500	7,500	7,200	46,000	9,000
2015/16	37,500	7,500	9,500	57,500	9,500
2016/17	45,000	9,500	12,500	54,000	7,000
2017/18		9,500	15,750		7,500

Licensee A: income has remained relatively steady with a 25% increase over the period, now at $1.2 million, has MDA authorisation
Licensee B: small one owner principal with turnover of $230,000p.a.
Licensee C: small one owner principal with 2 support staff and turnover of $550,000p.a.
Licensee D: income has remained steady at $2 million
Licensee E: strictly life insurance advice, small one owner principal with turnover of $350,000p.a.

To see how these changes correlate with changes to the EDR scheme compensation caps, the two distinct cohort groups have been grouped together:





Comparison of PI premium changes - Licensees A & D
Actual annual premiums ($)
70000
60000
50000
40000
30000
20000
10000
0
600,000
500,000
400,000
300,000
200,000
100,000
0
FOS/FICS compensation cap ($)
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
Year
Licensee D
Licensee A
Relevant ombudsman compensation cap