

## Chapter 7: Conclusions

This Chapter provides an overview of the report and its findings and conclusions. It sets out a number of recommendations for further action as proposed elsewhere in this report.

7.1 In this report I consider the adequacy of compensation arrangements for the protection of consumers in the financial services sector. I have had regard to experience over a number of years since the *Financial Services Reform Act 2001* was introduced and implemented.

7.2 I consider in particular the case for a more comprehensive statutory compensation scheme to protect consumers of financial services. In essence the question is whether consumers who have claims against a financial services firm, arising from the misconduct of that firm, should have resort to a scheme of last resort in circumstances where the firm becomes insolvent or is otherwise unable to meet those claims.

7.3 The assumption and management of risk and trade-offs between risk and reward are inherent for those who participate or invest in financial markets, services or products. The regulatory framework imposes standards of conduct and disclosure on the providers of financial services and offers remedies for those who suffer loss or damage where those standards are not met. It does not however generally seek to eliminate risk for those participants.

7.4 The regulatory regime provides an additional level of protection for retail participants on the basis that they are likely to be less well informed or able to take care of their own interests than wholesale participants. The high cost — in economic, social and human terms — that can ensue for individuals who suffer loss in the financial markets becomes readily apparent in the aftermath of the failure of financial products or institutions. There is a heavy toll on individual lives and families where for example they lose their life savings or retirement nest egg through unwise or inappropriate investment.

7.5 These issues are pronounced in circumstances where, as has been the case for some years now, individuals are encouraged to participate in the financial markets and, through superannuation, to take more responsibility for their own future financial security. The experience of such investors, and any sense of grievance where they feel let down by participants on whom they rely, can affect overall confidence in the sector.

7.6 The more recent collapse of Trio Capital, currently the subject of inquiry by the Parliamentary Joint Committee on Corporations and Financial Services, has thrown up further issues about the ability of consumers to recover compensation following the failure of a financial product in circumstances involving fraud.

7.7 It became apparent early in the review that the question of a last resort scheme could not be looked at in a meaningful way in isolation. It needs to be addressed more holistically in the context of the overall regulatory arrangements for the financial services sector, including the current regime for the protection of consumers, the characteristics of the market and the way in which participants interact in practice.

7.8 The various elements of the system are interconnected and adjustments or changes to one element can affect the balance elsewhere. The conferral of new rights and obligations on participants in one area who will benefit or bear a cost may have unintended consequences for firms or consumers elsewhere in the system. It can also have the effect of highlighting unevenness in the position of some participants, who will benefit or bear a cost, and that of others who are treated differently.

7.9 The challenge is to strike a balance between the effectiveness of any enhanced compensation arrangements in protecting retail participants and promoting confidence in the financial services sector, and their impact on the cost and supply of financial services to retail clients and the overall efficiency of the sector.

## **Regulatory framework**

7.10 We already have a relatively well developed system for the regulation of the financial services sector and for the protection of consumers. This includes:

- a system of licensing for firms that provide financial services;
- an array of enforceable legal obligations and rights;
- relatively well resourced and empowered regulators in ASIC and APRA;
- a readily accessible ombudsman system for consumer redress as well as access to the courts.

7.11 Licensed financial services firms have a responsibility to meet their own obligations to consumers including to compensate for losses arising from any misconduct. The risk to consumers in this as in other areas of trade, commerce or personal transactions is that a party who owes them money may become insolvent or otherwise be unable to pay.

7.12 Consumers are already provided with enhanced protection against that risk in the sensitive areas of bank deposits, general insurance and APRA-regulated superannuation funds. Firms providing products of those kinds are subjected to a more intensive form of regulation — prudential regulation — designed to reduce the risk of firm failure. This approach recognises the intensive nature of the financial promises in question and the potentially dire risks posed by firm failure to consumers and the financial system. Moreover, last resort schemes have been introduced to provide a measure of compensation to consumers if a firm in one of those sectors does fail, notwithstanding the prudential regulation to which it was subject. The cost of such compensation is recouped by levies imposed on all firms in the relevant industry sector.

7.13 Likewise clients of stockbrokers are provided with additional protection by a relatively tight system of regulation that applies to brokers and other participants in ASX and other licensed markets. That system is underpinned by a safety net — the National Guarantee Fund in the case of ASX — to cover claims by clients if a broking firm fails.

## **Default compensation arrangements**

7.14 The focus of the review has been on the adequacy of the default arrangements for protection of consumers in those areas of financial services that are not covered by the more intensive level of protection, including the last resort arrangements that are available to deposit holders, general insurance policy holders, members of APRA-regulated superannuation funds or clients of stockbrokers.

7.15 Under these default arrangements firms who provide financial services are required to be licensed and to comply with stipulated standards in their conduct towards clients and in the disclosure of information to their clients. Consumers who suffer loss or damage by reason of the misconduct of a licensee with whom they have dealt can pursue claims against that licensee. They can do this through the courts or an external dispute resolution scheme such as the Financial Ombudsman Service (FOS).

7.16 While there are measures in place to provide consumers with a degree of assurance, there is no last resort scheme to provide a safety net following the failure of a firm against which they have outstanding claims for compensation. The current arrangements rest on a legislative declaration that financial services licensees who deal with retail clients should have arrangements for compensating those clients for loss or damage attributable to a licensee's breach of its statutory obligations. The legislation itself leaves open the nature of those arrangements.

7.17 As they have been implemented by regulation and by ASIC, the compensation arrangements call on most licensees to hold professional indemnity insurance cover that is adequate for their business. Other licensees, mostly firms that are prudentially regulated, are exempt from any such requirement on the basis of their apparent financial strength and ability to meet claims for compensation from their own resources.

7.18 The exemption of APRA-regulated deposit takers and insurers from the requirement to hold professional indemnity insurance appears reasonable and does not appear to have given rise to problems. They are presumed to have the financial capacity effectively to self insure against the risk of compensation claims from clients.

7.19 Professional indemnity insurance works by assisting licensees to meet claims by clients and reduces the risk that retail compensation claims will not be met due to a licensee's lack of financial resources. It provides a valuable buffer but, under current regulatory arrangements, limited assurance that a licensee will be able to compensate a client who suffers loss from a breach of a licensee's statutory obligations. Whether or not a licensee in fact maintains insurance cover, and cover that is adequate by ASIC standards, is left largely to the licensee's own judgment.

7.20 In some cases a policy will no longer be in force or it may not respond to a particular claim or provide sufficient cover. Insolvency issues, policy exclusions, and gaps in the cover that the market will provide, as well as caps on the amount of cover taken out, limit the extent to which professional indemnity insurance can ensure that clients are in fact compensated where they succeed in a claim against a licensee.

7.21 There is also a question whether in practice licensees are maintaining professional indemnity insurance that is adequate to their needs.

7.22 The light-handed nature of the primary level of regulation designed to make licensees responsible to meet their own compensation obligations is noteworthy:

- ASIC largely relies on licensees to decide what insurance cover is adequate for their needs and to maintain that cover. There is very little checking or pressure on licensees in this regard; and
- the standard of adequacy for compensation arrangements is largely dependent on regulatory guidance by ASIC.

## **Uncompensated claims**

7.23 Where a licensee does not have a policy that responds to a successful claim the licensee remains under an obligation to meet that claim. A client's prospects of recovering compensation will depend on the available resources of the licensee. The compensation arrangements do not require licensees in general to maintain any significant level of financial resources apart from insurance cover.

7.24 The risk for a client with a compensation claim is that the licensee may have stopped trading, become insolvent or have insufficient assets. Moreover, where a licensee becomes insolvent any insurance cover it holds is likely to come to an end and not cover claims made thereafter.

7.25 Overall the current arrangements appear to provide a fair measure of assurance that consumers will be able to recover compensation for loss or damage resulting from licensee misconduct. FOS has said that in the vast majority of complaints it handles against financial services licensees, consumers who get a decision in their favour will be paid.<sup>1</sup>

7.26 In some cases however consumers with a claim against a licensee are left out of pocket following the disappearance or failure of the licensee. These claims could be based on grounds such as failure to carry out a client's instructions or the misappropriation of funds entrusted to a licensee for investment purposes. Commonly however the claims in question follow the failure of a financial product, generally a managed investment scheme, and are based on inappropriate advice in the selling of that product.

7.27 There is surprisingly little quantitative data about compensation claims by consumers based on licensee misconduct and the extent to which they are not met by licensees. Not a lot of attention appears to have been paid to the collection of such information on a systematic basis. Notwithstanding efforts by ASIC and FOS to quantify the shortfall in the current arrangements, there is limited information on the number and size of claims where consumers are unable to recover compensation following the failure of a licensee. It is not clear either whether failed licensees maintained adequate insurance cover while they were still in business.

7.28 What ASIC and FOS do say is that a number of small and medium sized licensees are likely to be wound up each year with outstanding compensation liabilities running to several million dollars. On this basis it appears that the incidence of claims where consumers cannot recover compensation to which they are entitled

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<sup>1</sup> Alison Maynard, Ombudsman, Financial Ombudsman Service, testimony to the PJC Inquiry into the collapse of Trio Limited, Hansard 30 August 2011, page 8.

is substantial but not all that large in overall terms. There is no denying the potential seriousness of the consequences for individual consumers who miss out on compensation in such circumstances.

## **Limits of compensation arrangements**

### **Compensation for licensee misconduct not investment failure**

7.29 It needs to be stressed that consumers generally do not have a claim against a licensee by reason only of the failure of the product or poor investment performance, other than any rights they may have as creditors in the insolvency of a product issuer. Losses suffered by consumers upon the failure or poor performance of an investment in which they have put their money are not in themselves compensable now and would not be compensable under a last resort scheme or other measures canvassed in this report. Such losses are only compensable where they can be attributed to a breach of a licensee's obligations.

### **Limited recourse where financial products purchased direct**

7.30 Retail clients only have a claim against a licensee where they can point to loss or damage suffered as a result of breach of a duty or other obligation of the licensee. It has become apparent in the review that the failure of financial products, and managed investment schemes in particular, underlies many cases of large case consumer loss. In such cases a common issue appears to be that the consumers had not been properly informed of, or had not understood, the complexity, suitability or risks of their investments.

7.31 Following the failure of an investment product claims are commonly brought against advisers for mis-selling of that product. It may be claimed for example that the product in question was inappropriate for the consumer's circumstances, or that too large a proportion of the consumer's funds were invested in that product.

7.32 While in theory a consumer might have a claim against the product issuer for misconduct, at least where that issuer is licensed, consumers do not have much success in practice in pursuing such claims. There are a few reasons for this including the difficulty of attributing liability to a product issuer for misrepresentation or mis-selling, and the reluctance of consumers to pursue a claim against a licensee that has failed. It follows that the introduction of a last resort scheme would be of little help to the sizeable proportion of consumers who invest in financial products direct and do not go through advisers.

### **Imbalance in responsibilities of licensees**

7.33 Financial advisers make the point that in practice they bear a lot of responsibility for their part in the investment chain compared to the issuers of products whose failure leads to the losses suffered by consumers. Without suggesting that financial advisers should be relieved of responsibility for their own conduct, there is a reasonable basis for their concern. Where no other avenue for compensation is available, there is an understandable effort to attribute responsibility to licensees who played a part in putting a consumer into an investment that ultimately failed. It would be timely to consider ways to redress this imbalance. Such measures could include

putting more responsibility on issuers for the suitability of a product for retail investors and to address relevant risk factors in a more meaningful way in their disclosure.

7.34 Moreover, given that many of the more egregious instances of consumer loss relate to the failure of managed investment scheme products wider questions about the regulatory and governance frameworks for such schemes, and their risk management obligations, may call for consideration.

### **Exposure to outlaws**

7.35 It should be noted too that the consumer protection regime is built upon a licensing system for providers of financial services. With any licensing system there is always a risk to consumers who deal with individuals or firms operating outside the licensed environment. This may occur where firms conform their business to take advantage of exemptions or where they ignore the licensing requirements and carry on business as outlaws. A scheme of last resort or other measures to underpin the licensing system for financial services providers will not help consumers who are left in the lurch by firms which operate outside that system.

### **Product failure through fraud**

7.36 The case of Trio Capital, where the facts and legal liabilities are still unfolding, has thrown into sharp contrast the problems some categories of consumers face in circumstances where the value of investments in a managed investment scheme appears to have been wiped out by fraudulent activity.

7.37 Consumers who were exposed to Trio Capital through their membership of an APRA-regulated superannuation fund were able to benefit from compensation pursuant to the last resort arrangements provided under the *Superannuation Industry (Supervision) Act 1993* (the SIS Act). Other consumers who were exposed to loss from fraud in Trio, whether through self managed superannuation funds or as direct investors, would need to establish that the licensee had engaged in dishonest conduct in breach of section 1041G or a breach of other provisions of the Corporations Act. Whether or not in the facts and circumstances of that case they will be able to claim against a licensee for loss or damage caused by a breach of its obligations remains to be seen.

7.38 The fact that the alleged fraudulent conduct in Trio Capital appears to have occurred in relation to a managed investment scheme, in which assets of prudentially-regulated superannuation funds amongst others were invested, rather than in the superannuation funds themselves, accentuates the difference in the position of the members of those funds who were able to be compensated, and the self managed superannuation funds and other consumers who invested in the same managed investment scheme. The introduction of a last resort scheme would not in itself resolve the question whether fraud as a factor in the diminution of the value of an investment would give rise to a claim against a licensee for compensation. Such a scheme would however provide some assurance of compensation where a consumer is able to establish breach of a relevant obligation by the licensee.

### **Enhancement of consumer protection**

7.39 There is a case for bolstering the current default regime for the assurance of compensation to consumers who suffer loss or damage from licensee misconduct. It

is important however to maintain a sense of proportion about the problems, the priorities and what can be achieved.

7.40 The underlying promise by licensees — that they will compensate retail clients for losses attributable to any misconduct on their part — is significant but may be regarded as less intensive than the promises underlying prudentially-regulated services such as deposit taking, insurance or superannuation. It is important therefore to keep in mind the cost and impact of any new measures.

## **Last resort scheme**

7.41 I caution against looking to the introduction of a last resort scheme to underpin the compensation arrangements as a shortcut means of remedying shortcomings in the current regime.

7.42 In my view the introduction of a last resort scheme to underpin the existing arrangements would not address the underlying problems. I have concluded that it would be inappropriate, and possibly counter-productive, to introduce such a scheme at this stage.

7.43 A last resort scheme would have the effect of imposing on better capitalised and/or more responsibly managed licensees the cost of bailing out the obligations of failed licensees. It would not work to improve the standards of licensee behaviour or motivate a greater acceptance by licensees of responsibility for the consequences of their own conduct. It could well introduce an element of regulatory moral hazard by reducing incentive for stringent regulation or rigorous administration of the compensation arrangements.

7.44 What has stood out in this review is the relatively light-handed nature of the primary level of regulation designed to put financial advisers and other licensees in a position to meet their own obligations to consumers. It is not tight enough in my view to provide an appropriate filter to limit the instances in which consumers are unable to recover compensation and for which it might be reasonable to look to other licensees to meet the cost. For example:

- ASIC largely relies on licensees to decide what insurance cover is adequate for their needs and to maintain that cover. There is very little in the way of checking or other pressure on licensees to comply. It is in essence an honour system. While it may be reasonable to expect most licensees to act responsibly in this regard, there is cause for concern that less well managed firms, or firms that are financially stressed, may cut corners in regard to their insurance cover.
- ASIC's powers in administering the licensing system including its ability to enforce its own view of what is required and to sanction firms that do not comply are quite limited and the standard of adequacy for compensation arrangements is largely dependent on regulatory guidance by ASIC;
- In practice ASIC, in juggling its responsibilities and resources, has put limited effort into monitoring the compliance record of licensed firms. While its resources will always be stretched I see a need for ASIC to be more pro-active in a targeted fashion.

- ASIC acknowledges that there is a problem with phoenix type activity in this area with firms folding with unpaid compensation obligations and the principals then re-emerging in another firm. There is a pressing need to address this problem. The existence of outlaws who operate outside the licensing regime in providing financial services also calls for concerted regulatory attention.
- As a practical matter some licensees such as financial advisers can carry on business with a relatively low level of capitalisation. There is virtually no regulatory requirement for them to maintain a level of financial resources that would provide some buffer, in addition to any professional indemnity insurance held, and expose them to risk ('skin in the game'), in the event of consumer claims.

7.45 This light-handed regulatory approach may be contrasted with the more robust regulatory approach to the providers of services elsewhere in the financial system, including prudential regulation, where last resort protection is offered to consumers.

## Further measures

7.46 My conclusion is that it would be better to proceed step-by-step and aim to strengthen the current approach as a necessary first stage before consideration is given to any move to a more comprehensive scheme of last resort to deal with compensation claims for licensee misconduct in circumstances where the licensee has become insolvent.

7.47 Action to enhance the protection of consumers should be directed on the one hand at reducing the incidence of licensee misconduct that causes loss or damage to the consumers of financial services. The *Future of Financial Advice* reforms, which seek to clarify and reinforce the duties of financial advisers, fall into this category.

7.48 The further measures or directions I propose recognise, and are intended to complement, the legislative and regulatory steps already being taken to raise the standards of professionalism by financial advisers and to improve the financial literacy of consumers including:

- Recent or proposed changes to the Corporations Act which:
  - require lenders to lend responsibly and clarify margin call arrangements through the regulation of margin loans as financial products;<sup>2</sup>
  - lift the professional standards and conduct of financial advisers and quality of advice through the *Future of Financial Advice* package now before Parliament, and related measures, which include:<sup>3</sup>
    - : a best interest obligation requiring an adviser to act in the best interests of the client when providing personal advice, and to give priority to the needs of the client if conflict arises;
    - : a ban on conflicted remuneration structures and a requirement for advisers to send renewal notices and fee disclosure statements to their clients;

<sup>2</sup> Section 985K *Corporations Act 2001*.

<sup>3</sup> Corporations Amendment (Future of Financial Advice) Bill 2011 and Corporations Amendment (Further Future of Financial Advice Measures) Bill 2011.



- : the lifting of professional standards for financial advisers, including through competency requirements and training.<sup>4</sup>
- Ongoing efforts to improve the financial literacy of consumers and help equip them to look out for their own interests and understand the risks in making investment decisions or otherwise utilising financial services. ASIC for example provides basic information through its new *MoneySmart* website and has announced a national financial literacy strategy to be delivered through mainstream education, the workplace and in the community.<sup>5</sup> Programs of this kind are clearly necessary and have the potential in the longer term to empower consumers and bridge the gap that too often exists between their level of knowledge and understanding and that of the providers of financial services with whom they deal.

Measures of this kind should work over time to reduce the instances of egregious licensee misconduct. They are unlikely however to remove the risk of licensee misconduct altogether.

7.49 Beyond measures of that kind the critical need in my view is to develop a more robust and effective system to make licensees responsible for the consequences of their own conduct. This approach, while it will have a cost will in itself provide licensees with incentive to raise their standards and reduce the incidence of consumer claims based on misconduct. This in turn could lead over time to beneficial changes in the supply and cost of insurance to licensees.

7.50 The aim should be to reduce the number of cases where consumers cannot recover compensation for losses suffered through licensee misconduct because of the financial failure of the firm in question. To put it another way, the regulatory platform for financial advisers and other licensees needs to be made more robust and stable before a safety net, funded by all licensees, is suspended beneath it.

7.51 A relatively stringent primary platform of regulation is a feature of professional and other compensation schemes which are underpinned by schemes or funds of last resort. Accordingly, in any effort to bolster the regime for the protection of consumers the initial focus, in conjunction with the *Future of Financial Advice* reforms and other efforts to raise industry standards, should be on developing a more robust and effective system to make licensees responsible for the consequences of their own conduct. This could be done by:

- placing more onus on licensees to establish that they in fact have adequate insurance cover;
- in conjunction with requiring licensees to be able to demonstrate that they have capital at risk in their business;
- together with steps where necessary to strengthen ASIC's ability to police the licensing system; and
- a more pro-active stance by ASIC targeted at licensees who are most at risk.

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4 A newly established advisory panel on financial advice and professional standards will provide views to the Government on professional standards for financial advisers. The panel has been involved in ASIC's development of a framework for assessment and professional development of financial advisers - ASIC Consultation Paper 153, *Licensing: Training and assessment framework for financial advisers*, April 2011.

5 ASIC, Report 229 *National Financial Literacy Strategy*, March 2011, and [www.moneysmart.gov.au](http://www.moneysmart.gov.au).

7.52 A more robust regulatory approach along these lines will not be cost free. While it is not suggested that financial advisers and other licensees should be subjected to prudential regulation any increased cost of holding adequate professional indemnity insurance or meeting a financial adequacy test may have the effect of raising barriers to entry or add to pressure for some firms to consolidate. There could be some tension in this regard with the policy objective of promoting consumer access to financial advice. However, I see some tightening of the current regulatory approach as a necessary first step if it is desired to give more substance to the legislative recognition in section 912B of the need for protection of consumers who are let down by licensees with whom they deal.

7.53 The report also addresses the imbalance in the responsibilities of product issuers and financial advisers towards consumers. Given that most cases of serious consumer loss relate to the failure of financial products, it would be timely as a matter of strategic approach to review the present relatively light-handed regulation of certain product issuers, in particular managed investment schemes. Such a review could include the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach. As a first step consideration could be given to imposing on licensees who make products available for retail clients more responsibility for the suitability of those products for such investors, together with related disclosure obligations.

7.54 Given the attention afforded in the review to a last resort scheme, including the proposal put forward by FOS, I have set out in Chapter 6 my views on the design and governance of such a scheme should it be desired to proceed with one. I make the point that ideally any last resort scheme would be integrated as far as possible with the National Guarantee Fund at least, if not the Financial Claims Scheme and the last resort arrangements under Part 23 of the SIS Act. The existing last resort arrangements have developed in a piecemeal fashion. There would be advantages in terms of clarity, efficiency and cost in integrating their administration. The Financial Services Claims Scheme in the United Kingdom provides an example of a comprehensive scheme which brought together a number of schemes that previously operated in the industry.

7.55 I suggest however that it would be preferable to defer further consideration of any such scheme pending the implementation of the measures I propose, as well as other changes underway in the financial services sector, including the *Future of Financial Advice* reforms. Deferral would also allow time to get a clearer picture of any remaining shortcomings in the compensation arrangements, and the likely costs of such a scheme.

## Recommendations

In summary the recommendations in this report are directed to the following matters.

### Last resort scheme

#### Recommendation 1: Last resort scheme

It would be inappropriate and possibly counter-productive to introduce a last resort compensation scheme at this stage.

### Strengthen current compensation arrangements

In any move to strengthen the regime for the protection of consumers the initial focus, in conjunction with the *Future of Financial Advice* reforms and other efforts to raise industry standards, should be on developing a more robust and effective system to make licensees responsible for the consequences of their own conduct. Recommendations for changes to strengthen the current compensation arrangements are summarised below.

Reference is also made in Chapter 4 to initiatives by industry bodies, brokers and insurers to develop insurance solutions that better cater for the specific obligations on licensees to hold adequate professional indemnity insurance. Initiatives of this kind are acknowledged and should be encouraged.

#### Recommendation 2.1: Licensees to demonstrate adequacy of their insurance

Require licensees to provide ASIC with additional assurance that their professional indemnity insurance cover is current and is adequate to their business needs.

#### Recommendation 2.2: Licensees to hold appropriate capital resources

More attention should be given, on a risk targeted basis and in conjunction with the level of their insurance cover, to the adequacy of licensees' financial resources to enable better management of risks and unexpected costs such as compensation liabilities.

#### Recommendation 2.3: A more pro-active stance by ASIC

ASIC should take a more pro-active approach in monitoring licensee compliance with the requirement to hold adequate professional indemnity insurance cover and any new requirement in regard to financial resources, and in targeting licensees who are most at risk.

#### Recommendation 2.4: Policing the licensing system in regards to compensation

To assist ASIC in playing a more pro-active role in administering the licensing regime with respect to compensation arrangements, consideration should be

given to clearer powers to enforce standards and to sanction licensees who do not comply through:

- : powers to deal with phoenix activity, both through licensees establishing new entities or by former directors who re-emerge in the industry as authorised representatives;
- : ability to deal with disreputable industry participants; and
- : access to an infringement notice regime.

ASIC for its part should be prepared to take action in appropriate cases to enforce its published views of what is required by the licensing conditions on insurance cover or financial resources. In the event that it becomes apparent that the current legal framework provides insufficient basis for effective enforcement action, consideration should be given to clearer legislative backing for regulatory standards on the adequacy of insurance or financial resources.

#### Other matters

The following issues relevant to the provision and operation of compensation arrangements and the protection of consumers, referred to in Chapter 4, should be addressed.

#### Recommendation 2.5.1: Compensation where licensees cease to trade

In dealing with licensees who give up their licence or reduce the scope of their licensed activities, ASIC should seek where possible to secure ongoing protection for retail clients including by imposing appropriate conditions in relation to the termination of a licence or the amalgamation or takeover of a licensed business.

#### Recommendation 2.5.2: Protection from unlicensed providers

There are risks to consumers where they deal with financial services providers that:

- : have a licence, but operate beyond the scope of that licence because they provide products or services that are not covered by the licence; or
  - : should be licensed under the Corporations Act but are not,
- and accordingly have limited or no compensation arrangements.

While acknowledging the difficulties in identifying outlaw activity, the importance of concerted enforcement effort by ASIC to police the boundaries of licensed financial service activities is emphasised. In its approach to the handling of complaints about outlaw activities ASIC should be transparent and provide as much feedback to complainants as possible in order to encourage further assistance.

#### Recommendation 2.5.3: Third party rights under licensee's insurance policy

(a) Where a licensee (or its administrator or liquidator) does not respond to claims from a consumer or the licensee cannot be contacted after reasonable inquiry, ASIC should be able to provide the consumer with information it has about the insurance policy including the name of the insurer and the policy number. This would assist the consumer to decide whether there is a prospect of recovering compensation should the claim proceed and be successful.

(b) The third party rights provisions of the *Insurance Contracts Act 1984* should be extended, as was proposed by a review of that Act in 2004, to apply where a consumer cannot recover compensation awarded against the insured and there is capacity to meet that liability from the insured licensee's professional indemnity insurance policy.

#### Recommendation 2.5.4: Defence costs

ASIC should give further consideration, in its approach to the adequacy of professional indemnity insurance cover, to the treatment of defence costs with a view to striking a reasonable balance between the interests of licensees and insurers on the one hand, and consumers on the other.

#### Recommendation 2.5.5: External Dispute Resolution scheme processes

Given their key role in the regime for the protection of consumers of financial services, and marked increases in their jurisdiction, External Dispute Resolution schemes and ASIC should give more attention to the adequacy of the EDR scheme processes as those schemes grow beyond their origins as forums for small claims. Issues for consideration include: rights of review; transparency; capacity of a member to join in a proceeding other members that might be liable; cost contribution by complainants; liability standards; relevance of regulatory guidance and other operational issues discussed in Chapter 2.

### **Rebalance responsibilities of licensees**

Having regard to an apparent imbalance in the responsibilities of product issuers and financial advisers towards retail clients, and the fact that most cases of serious consumer loss relate to the failure of financial products, consideration should be given to measures to enhance the responsibilities of product issuers and the protection offered to retail clients. This would pave the way for possible compensation claims against issuers where their obligations are breached.

#### Recommendation 3.1: Review regulation of product issuers

As a matter of strategic approach, it would be timely to review the present relatively light-handed regulation of certain product issuers, in particular managed investment schemes, including the possible need, in accord with developments at the international level, to move to a somewhat more interventionist approach.

It would be appropriate also, in the course of any such review, to direct more attention to the responsibilities of licensees who provide financial products for retail clients. While the review has not had an opportunity to test these proposals, a first step might be to consider measures along the following lines by which product issuers would be expected to assume more responsibility for the protection of consumers of their products:

(a) Subject product issuers to more positive obligations in regard to the suitability of their product for retail clients.

Such obligations might be applied in particular to managed investment schemes in issuing products to the retail market, and would apply at each stage of a product's life cycle including its distribution and marketing. Amongst other things, the product issuer might be required to state the particular classes of consumers for whom the product is suitable and for whom the product is unsuitable, and the potential risks of investing in the product.

A stronger approach by managed investment schemes to the management of risk of fraud, particularly by employees or representatives, might also be sought.

(b) Consider the development of standardised product labelling so that financial products, particularly managed investment schemes, are described on a consistent and more meaningful basis.

This might apply to such terms as *capital guaranteed, capital protected, conservative, balanced, diversified, growth, defensive, fixed interest, or hedged*, as well as other like descriptors.

(c) While the review has not looked into these matters in any depth, the significance of the role of gatekeepers, such as research houses, should be kept in mind in any strategic consideration of consumer protection in the financial services sector.

### Recommendation 3.2: Responsibility of product issuers through EDR schemes

Some rebalancing of responsibilities of product issuers and financial advisers towards retail clients could be addressed through changes to the operation of EDR schemes by resolving the inability of EDR schemes to apportion responsibility for misconduct amongst responsible licensees. The operating rules of EDRs should be changed to enable them to make awards that recognise the proportionate liability of product issuers, financial advisers or other licensees.

Further, consideration should be given to the clarification of clause 5.1(i) of the terms of reference of FOS which excludes consideration of disputes about the 'management of the fund or scheme as a whole'. The aim would be to remove any doubt about the ability of FOS to deal with consumer disputes in respect of misleading product disclosure statements or other practices of issuers in marketing their products.